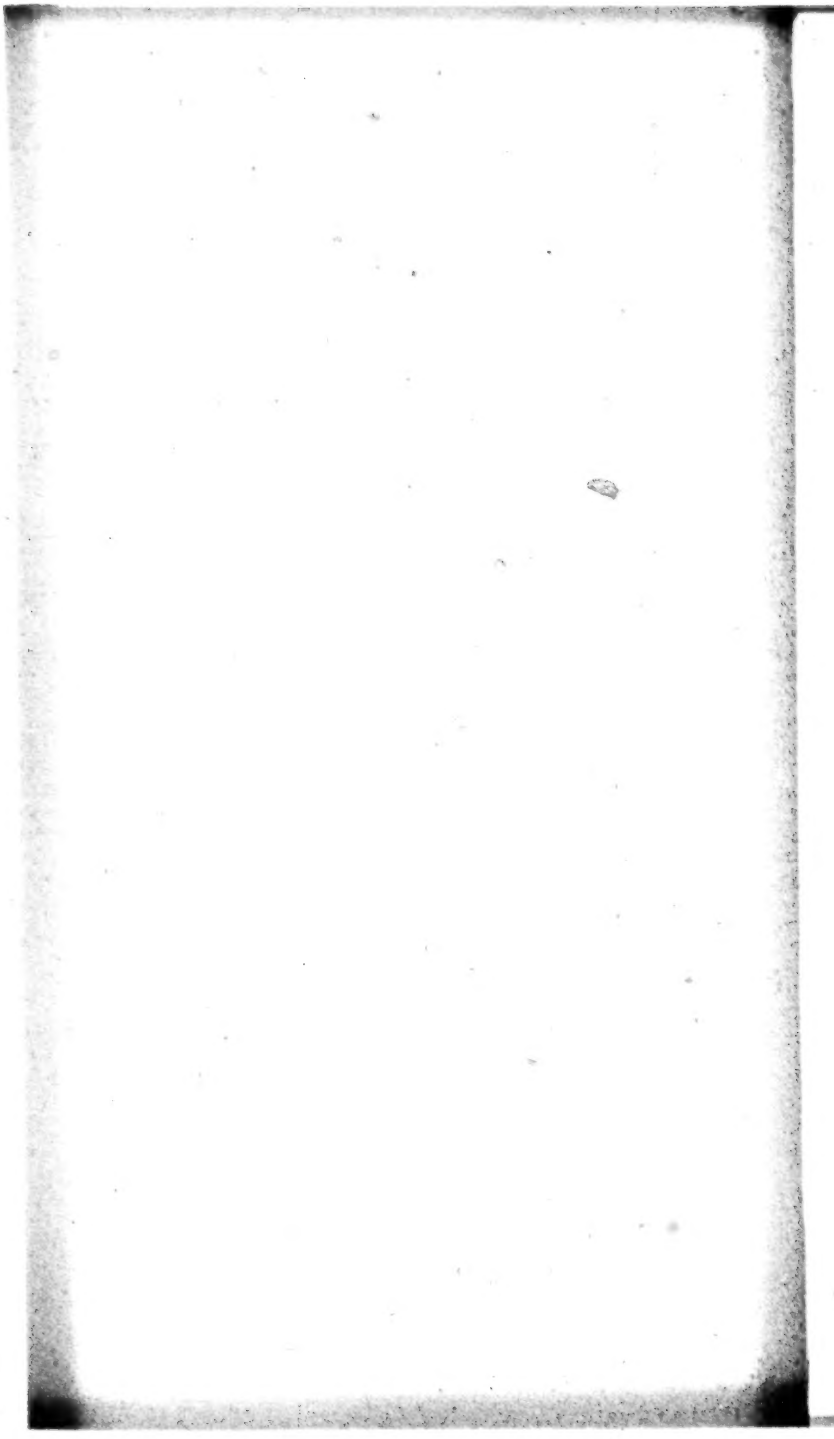

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SUPREME COURT, U. S.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-439

LEHMAN BROTHERS,

Petitioner,

v.

JACOB SCHEIN; MARVIN H. SCHEIN; ANTONE F. GREGORIO; LUM'S INC.; MELVIN CHASEN; BENJAMIN SIMON; INVESTORS DIVERSIFIED SERVICES, INC.; INVESTORS VARIABLE PAYMENT FUND, INC.; IDS NEW DIMENSIONS FUND, INC.; EUGENE S. SIT; and JAMES R. JUNDT,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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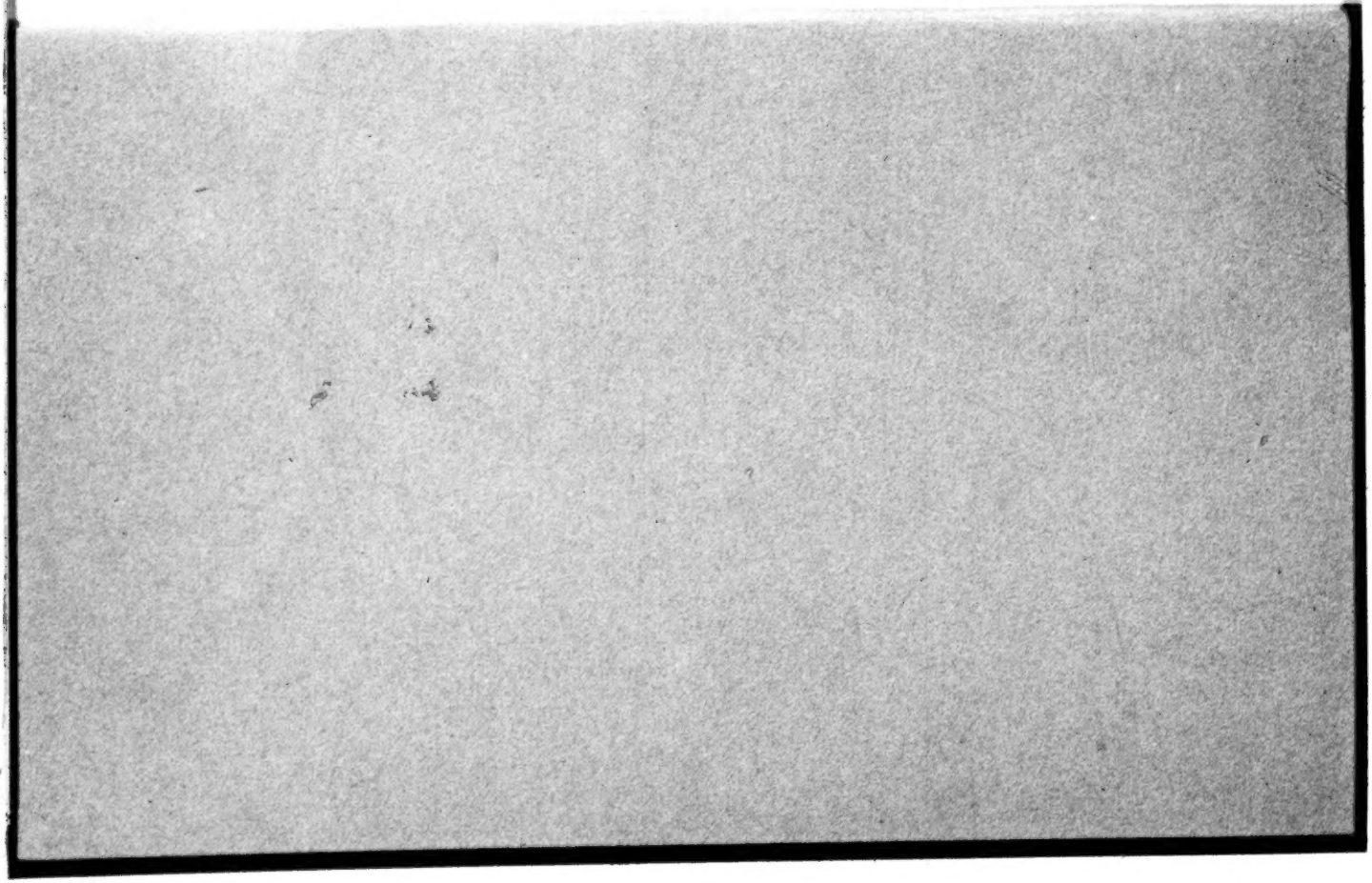
September 6, 1973



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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No.

LEHMAN BROTHERS,

Petitioner,

v.

JACOB SCHEIN, *et al.*,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Lehman Brothers ("Lehman") petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit entered on May 10, 1973 and the order of that court entered on June 8, 1973 denying Lehman's petition for rehearing in banc. The court below reversed the order of the United States District Court for the Southern District of New York, which had dismissed the complaints against Lehman and the other defendants.

Opinions Below

The majority and dissenting opinions of the Court of Appeals, rendered May 10, 1973, are reported at 478 F.2d 817 (12A[1]); the opinion of the District Court, which was

1. Citations with the suffix "A" are to the Appendix hereto.

reversed by the Court of Appeals, is reported at 335 F. Supp. 329 (1A).

Jurisdiction

The judgment of the Court of Appeals was entered on May 10, 1973 (33A), and a timely petition for rehearing filed by the petitioner herein was denied by the Court of Appeals on June 8, 1973 (36A). This petition was filed within 90 days of that date. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

Questions Presented

1. In this diversity action brought in the Southern District of New York, but governed by Florida law, should the Court of Appeals have certified the decisive issue of law to the Supreme Court of Florida, in accordance with established practice in other circuits, to permit the State Court to decide whether a novel rule of public policy would be adopted as the law of Florida, in a situation where Florida's interests are vital and paramount?

2. Has the Court of Appeals properly performed its duty under *Erie R. R.* v. *Tompkins,* 304 U.S. 64 (1938), in holding that Florida law gives a Florida corporation an equitable right to recover from a stockbroker profits allegedly made by a third party mutual fund on the ground that such mutual fund sold stock in the corporation on the basis of inside information received from a company officer through the stockbroker, where the stockbroker performed no transactions and made no profits?

Statutes Involved

Florida law, FLA. STAT. ANN. §25.031 (1961), provides that

> "The supreme court of this state may, by rule of court, provide that, when it shall appear to the supreme court of the United States, to any circuit court of appeals of the United States, or to the court of appeals of the District of Columbia, that there are involved in any proceeding before it questions or propositions of the laws of this state, which are determinative of the said cause, and there are no clear controlling precedents in the decisions of the supreme court of this state, such federal appellate court may certify such questions or propositions of the laws of this state to the supreme court of this state for instructions concerning such questions or propositions of state law, which certificate the supreme court of this state, by written opinion, may answer."

In addition the Supreme Court of Florida is enabled by statute to effectuate §25.031 by rulemaking, FLA. STAT. ANN. §25.032 (1961):

> "The supreme court of this state is hereby authorized and empowered to collaborate with any and all other courts of last resort, of other states and of the United States, in the preparation and approval of uniform rules of court to make effective this and similar laws."

Pursuant to §25.032, the Supreme Court of Florida promulgated FLA. APP. RULES, R. 4.61 (1967):

> RULE 4.61. Certified Questions from Federal Courts
>
> a. When Certified. When it shall appear to the Supreme Court of the United States, or to any of the Courts of Appeal of the United States that there are involved in any proceeding before it questions or propositions of law of this state which are determinative of said cause and that there are no clear controlling precedents in the decisions of the

Supreme Court of this state, such federal appellate court may certify such questions or propositions of law of this state to the Supreme Court of Florida for instructions concerning such questions or propositions of state law.

b. Jurisdiction. Questions or propositions of law referred to in sub-paragraph a hereof shall be certified for answer to the Supreme Court of this state.

c. Method of Invoking Rule. The provisions of this rule may be invoked by any of the federal courts referred to in sub-paragraph a hereof upon its own motion or upon the suggestion or motion of any interested party when approved by such federal court.

d. Contents of Certificate. The certificate provided for herein shall contain the style of the case, a statement of facts showing the nature of the cause and the circumstances out of which the questions or propositions of law arise and the question of law to be answered.

e. Preparation of Certificate. The certificate may be prepared by stipulation or as directed by such federal court. When prepared and signed by the presiding judge of said federal court, it shall be certified to the Supreme Court by the Clerk of the federal court and under its official seal. The Supreme Court may, in its discretion, require the original or copies of all or any portion of the record before the federal court to be filed with said certificate where, in its opinion, such record may be necessary in the determination of said cause.

f. Costs of Certificate. The costs of the certificate and filing fee shall be equally divided between the parties unless otherwise ordered by this Court.

g. Briefs and Argument. The appellant or moving party in the federal court shall file and serve

upon its adversary its brief on the question certified within 30 days after the filing of said certificate in the appellate court of this state having jurisdiction. The appellee or responding party in the federal court shall file and serve upon its adversary its brief within 20 days after the receipt of appellant's or moving party's brief and a reply brief shall be filed within 10 days thereafter.

h. Oral Argument. Oral argument may be granted upon application and, unless for good cause shown the time be enlarged by special order of the Court prior to the hearing thereon, the parties shall be allowed the same time as in other causes on the merits.

Statement of the Case

Lehman was named as a defendant in three shareholder's derivative suits brought in the Southern District of New York on the basis of diversity of citizenship, 28 U.S.C. § 1332(a)(1).[2] The complaints are similar; the actions have been dealt with on a consolidated basis below, and they are so treated here.[3] Plaintiffs are shareholders of the nominal defendant Lum's, Inc. ("Lum's"), a Florida corporation with its principal place of business in Miami. They allege

2. *Gildenhorn* v. *Lum's, Inc.*, No. 70 Civ. 5733 (filed Dec. 29, 1970); *Gregorio* v. *Lum's, Inc.*, No. 71 Civ. 1925 (filed Jan. 12, 1971); and *Schein* v. *Chasen*, No. 71 Civ. 4218 (filed Sept. 24, 1971).

3. Only the *Schein* and *Gregorio* cases are involved here, since an appeal in *Gildenhorn* was not pursued. The full captions of the actions, indicating the alignment of the parties, are as follows:

Jacob Schein and Marvin H. Schein, Plaintiffs, v. Melvin Chasen; Investors Diversified Services, Inc.; Lehman Brothers; Investors Variable Payment Fund, Inc.; Benjamin Simon; IDS New Dimensions Fund, Inc.; Eugene S. Sit; James R. Jundt; and Lum's Inc., Defendants.

Antone F. Gregorio, Plaintiff, v. Lum's, Inc.; Melvin Chasen; Lehman Brothers; Investors Diversified Services, Inc.; Eugene C. Sit; and James R. Jundt, Defendants.

that on January 8, 1970 the defendant Melvin Chasen, president of Lum's, with his office in Miami, telephoned the defendant Benjamin Simon, a registered representative in the Chicago office of Lehman, and disclosed certain unfavorable projections of Lum's earnings. Such information was not then public.

Allegedly Simon then gave this information to the IDS defendants[4] in Minneapolis. On the next day the IDS defendants allegedly sold 83,000 shares of Lum's common stock on the New York Stock Exchange at about $17.50 per share. Later that day the Exhange halted trading in Lum's stock, whereupon the company publicly stated that projected second-quarter earnings would be "substantially lower" than anticipated and that first-half earnings would be about 20% below the previous year's level (*Gregorio* complaint ¶ 20; *Schein* complaint ¶ 23). On the next trading day Lum's stock opened at $14.00 per share (*Schein* complaint ¶ 24).

The *Schein* complaint alleges that Chasen received the information in a fiduciary capacity and disclosed it in violation of that duty. (*Schein* complaint ¶¶ 16, 18, 25). It alleges that the other defendants aided and abetted such violation, used such information "for their own personal profit", and are liable to Lum's for such "unlawful profits (including commissions)" and for "the damages it sustained thereby" (*Id.*, ¶ 25), and it demands an "accounting" (*Id.*, ¶ 26). The *Gregorio* complaint alleges that the information was "an asset" of Lum's (*Gregorio* complaint ¶ 22)

4. The defendants Investors Diversified Services, Inc.; Investors Variable Payment Fund, Inc.; and IDS New Dimensions Fund, Inc. are collectively referred to as "the IDS defendants." The defendants Eugene S. Sit and James R. Jundt are alleged to be employees of Investors Diversified Services, Inc. Allegedly Sit received the information from Simon and gave it to Jundt. Both Sit and Jundt were dismissed from the cases by the District Court for lack of personal jurisdiction (2A n.1).

and that defendants "must account to Lum's, Inc. for the profits realized by them" (*Id.*).

Lehman, Simon, Chasen, and the IDS defendants moved to dismiss the complaints for failure to state a claim on which relief can be granted, FRCP 12(b)(6); Simon and Chasen also asserted a lack of personal jurisdiction, FRCP 12(b)(2). Affidavits of Simon and of Mr. Herbert Lisle, a Lehman partner, were presented on the motions and not excluded, FRCP 12(b). These established that the IDS defendants' sales were not executed by Lehman and that neither Lehman nor Simon received any benefit from the sales. The District Court's finding that the "broker-dealer defendants . . . did not profit by virtue of the sales" (6A) states the undisputed facts.[5]

The District Court, Hon. Harold R. Tyler, Jr., J., rejected the plaintiffs' arguments that New York substantive law applied; following New York choice of law principles, see *Klaxon Co.* v. *Stentor Electric Manufacturing Co.*, 313 U.S. 487 (1941), it held that the law of the state of incorporation, here Florida, governed the nature of fiduciary obligations to a corporation (3A-4A). It buttressed this conclusion with the "governmental interest" analysis applied by New York courts in resolving conflict of laws issues, finding Florida law controlling since

> "Florida has the paramount interest in defining and enforcing fiduciary obligations owing to corporations incorporated and doing business within its borders" (4A).

And it noted (*Id.*) that the New York Court of Appeals had expressly stated, as to fiduciary duties to corporations, that the

5. Plaintiffs had thirty days in which to file papers in opposition: they filed neither affidavits suggesting any factual issue, nor affidavits showing inability to present contrary evidence, FRCP 56(f). Thus there is no dispute that Lehman received no benefit in the transactions sued upon, FRCP 56(c).

> "primary source of law in this area ever remains that of the State which created the corporation." *Diamond* v. *Oreamuno*, 24 N.Y.2d 494, 503-04, 248 N.E.2d 910 (1969).

Examining Florida precedents, Judge Tyler noted that, although the Florida Supreme Court had not yet decided the issue, lower Florida courts had held that a shareholder's derivative complaint alleging breach of fiduciary duties was insufficient if it did not allege some form of damage to the corporation (5A).

Recognizing that the *Schein* complaint made at least a conclusory allegation of "damage" and also that out-of-state precedents might be argued to a Florida court, the court tested the allegations of the various complaints by the standards of a 1969 New York decision which the plaintiffs urged was dispositive, *Diamond* v. *Oreamuno, supra.*

In *Diamond,* the New York Court of Appeals held that directors of a corporation were liable to the corporation in a derivative action for profits they made by selling the company's stock based on inside information, the court reasoning that such information was an "asset" of the company which had been acquired by the directors as fiduciaries and misappropriated in violation of trust. Since under the usual rule a company can only recover from a fiduciary for loss of a lawful business opportunity, and since the company itself could not lawfully sell stock on inside information, the holding that the company has "a higher claim to the proceeds", *id.* 498, of wrongful market activity was a novel break from precedent (see Point III, *infra*).

The District Court, however, held that none of the defendants in these cases came within the *Diamond* rule. Chasen was a fiduciary, but he sold no stock and made no profits.[6]

6. The District Court was not required to determine whether Chasen came within an expanded view of *Diamond,* since he, the only fiduciary in the case, was dismissed as improperly served (7A).

The IDS defendants might have profited, but they were not fiduciaries. And Lehman and Simon were doubly excluded, since they were not fiduciaries, and they made no profits (6A). The court declined the plaintiffs' invitation to extend the rule of *Diamond* to hold liable corporate outsiders like IDS and Lehman, especially since such "outside individuals, corporations, or institutions" were already "subject to other private and governmental restraints on their behavior" (7A). Accordingly, the complaints were dismissed. Plaintiffs in the *Schein* and *Gregorio* cases appealed.[7]

The Court of Appeals, in an opinion by Judge Waterman (12A), held the complaints sufficient as to the IDS defendants, Simon, and Lehman.[8] Plaintiffs conceded on appeal, in a reversal of their position in the District Court, that Florida law controlled (14A n. 3), but the court found no pertinent Florida rulings (17A). In such case it felt free to turn to the "law of other jurisdictions and particularly that of New York where the resolution of the issues in the *Diamond* case . . . bears on the issues". (*Id.*) Having done so, the court said, its task was to "interpret *Diamond* as the Florida court would probably interpret it" (*Id.*). The only remaining question, it said, was "whether the *Diamond* holding should extend to reach third parties" who are "involved with directors in a common enterprise" (18A). Conceding that the complaints failed to allege any such common enterprise between the defendants and Chasen, the only fiduciary, the court said that a "common enterprise" might still be proved under the pleadings (*Id.*). And it held that nothing in *Diamond* excluded "co-venturers" from joint and several liability for a breach of fiduciary duty (19A).

7. An appeal in *Gildenhorn* v. *Lum's, Inc.*, No. 70 Civ. 5733, was noted but not pursued (14A n.2).

8. Dismissal of the defendant Chasen for lack of personsal jurisdiction was not challenged on appeal (27A n.2).

In so interpreting *Diamond,* the court stated that its purpose was to protect the interest of "the injured corporation" in its "prestige" and "good will" (20A). It also expressed fear that the "prophylactic effect" of *"Diamond,* the law of the jurisdiction in which the New York Stock Exchange is located", might be defeated if non-fiduciaries were "immunized" (*Id.*)[9].

The Court of Appeals held that Lehman and Simon might be liable to Lum's, even though they realized no profit from the IDS sales, under the "well established" principle that "persons engaged in a joint enterprise to commit a wrong" are liable "for the profits of other participants" (22A). The opinion closed with several citations to federal securities law decisions and the comment that:

> "Preventing those who are privy to confidential inside information from using it to their own advantage has found expression in numerous cases in the federal courts dealing with violations of the federal securities laws." (24A)

Judge Kaufman, in dissent (24A), agreed that those who profit by insider trading deserve "universal condemnation" (24A) but stressed that the majority had created a "totally new concept of law" (25A) that was wholly without precedent and amounted to

> "an extraordinary, expansive, and incorrect reading of *New York law*" (*Id.*) (emphasis supplied).

He pointed out that the foundation of the majority's theory, a fiduciary duty running to the corporation, was nonex-

9. In support of its ruling the court cited only one Florida case, *Quinn* v. *Phipps,* 93 Fla. 805, 113 So. 419 (1927), in which a real estate agent was held liable when, in conflict with his principal, he appropriated a business opportunity. The case does not concern and says nothing about the conduct of non-fiduciaries or the liability of persons who do not profit.

istent in the case of Lehman, Simon and the IDS defendants. The majority, he said, tried to "bridge this fatal gap" (28A) with the help of the "common enterprise" notion, which was not alleged in the complaints and seemed wholly "fictional" (*Id.*). Rather the complaints, generously read, disclosed "nothing more than a seemingly unsolicited and haphazard revelation of certain information" (*Id.*).

Judge Kaufman added that any loss to purchasers of stock from IDS could be fully remedied in private and government suits under federal law, which are now pending (25A). He stated that federal cases expanding the liability of "tippee" traders, relied on by the majority, appropriately gave great weight to the public interest in maintaining free and honest securities markets, but that such federal interests did not apply

> "in determining whether, *under state common law*, tippee trading is a breach of fiduciary duty owed to the corporation whose shares are traded, and if so, whether such a breach is remediable through use of a shareholders' derivative action" (30A) (italics original).

In closing, Judge Kaufman said he could not understand why the majority refused to use the "enlightened" (31A) Florida certification procedure to secure an authoritative ruling on a state-law point on which it was concededly without guidance:

> "The uncertainty inherent in the majority's speculation over what the Florida courts would decide if faced with this novel question of tippee liability under state common law fiduciary principles in a stockholders' derivative action would be dispelled authoritatively and finally" (32A).

Lehman made a timely motion for rehearing, in which it pointed out that *Diamond* v. *Oreamuno, supra,* constituted

an extreme minority position, if not a unique one, and that the majority had erred in assuming that Florida courts would both embrace and expand it. Lehman specifically requested that the question be referred to the Supreme Court of Florida for authoritative resolution pursuant to FLA. STAT. ANN. § 25.031 (Suggestion for Rehearing in banc by Appellee Lehman Brothers, at 9-10 (May 24, 1973)). The petition was denied (36A).[10]

Reasons for Granting the Writ

POINT I

In Refusing to Certify the Controlling Public Policy Issue to the Supreme Court of Florida, the Court of Appeals Departed from Prior Decisions of this Court.

The fundamental fact of this case is that Florida is the jurisdiction with the paramount interest in formulating the legal principle involved. The Court of Appeals recognized that there were no Florida decisions on point, but it refused, over dissent, to use the most certain way to determine Florida law, namely, by certification to the Supreme Court of Florida pursuant to a statutory procedure[11]. Instead, without statement of reasons, it imported the unique *Diamond* rule from New York and erroneously extended "the 'stretch' of *Diamond*" (19A) to penalize persons no state has ever held liable. Simply put, Lehman's position is this:

10. Motions for rehearing, including the suggestion that the case be heard in banc, were also made by Simon and the IDS defendants, and were likewise denied (35A, 37A, 38A).

11. FLA. STAT. ANN. §§ 25.031, 25.032 (1961); see "Statutes Involved", *supra*, pp. 2-3.

First, prior decisions of this Court required the Second Circuit to abstain from ruling and to permit Florida to decide this important issue of Florida law and public policy.

Second, since the Court of Appeals could have certified the question for a speedy and definitive ruling by the Supreme Court of Florida, its refusal to do so is doubly erroneous. It departs from the practice in other circuits and rejects a procedure this Court has used and encouraged other federal courts to use. The ruling below thus raises issues of recurrent importance to the fair and efficient administration of the federal courts.

A. The decisions of this Court required abstention.

It is commonplace that in specific circumstances where a lawsuit calls for decision of a difficult and unsettled question of state law, and an incorrect decision might cause unnecessary interference with state policies, a federal court will abstain from decision until the state court can rule authoritatively on the issue.

Thus abstention is proper if a constitutional question may be avoided:

> "The paradigm case for abstention arises when the challenged state statute is susceptible of 'a construction by the state courts that would avoid or modify the [federal] constitutional question. *Harrison* v. *NAACP*, 360 U.S. 167. Compare *Baggett* v. *Bullitt*, 377 U.S. 360,' *Zwickler* v. *Koota, supra*, at 249." *Lake Carriers' Association* v. *MacMullan*, 406 U.S. 498, 510-11 (1972).

Accord: *Askew* v. *Hargrave*, 401 U.S. 476 (1971); *Fornaris* v. *Ridge Tool Co.*, 400 U.S. 41 (1970); *Reetz* v. *Bozanich*, 397 U.S. 82 (1970); *Railroad Commission* v. *Pullman Co.*, 312 U.S. 496 (1941).

Avoidance of a constitutional issue is, however, only one of the concerns which compels abstention. In *Chicago* v. *Fieldcrest Dairies, Inc.*, 316 U.S. 168 (1942), the Court ordered abstention, declining to chance "needless friction with state policies" by a "tentative decision" on the effect of possibly conflicting state and city legislation on a private business, *id.*, 172, where the issues could be settled by "an authoritative and controlling determination by the state tribunals," *id.* The Court specifically noted that any constitutional issues did not seem substantial and that avoidance of such issues was only an additional ground for abstention, *id.*, 173.[12] In *Thompson* v. *Magnolia Petroleum Co.*, 309 U.S. 478 (1940), the Court ordered that the interpretation of certain documents, which granted interests in land to a bankrupt, be submitted to the courts of Illinois, lest the parties' rights be prejudiced because of "the accident of federal jurisdiction," *id.*, 484.

Thus several considerations traditionally call for abstention, such as avoiding interference with development of important state policies by aberrational federal decisions:

> "Reflected among the concerns which have traditionally counseled a federal court to stay its hand are the desirability of avoiding unseemly conflict between two sovereignties, the unnecessary impairment of state functions, and the premature determination of constitutional questions." *Martin* v. *Creasy*, 360 U.S. 219, 224 (1959).

In *Louisiana Power & Light Co.* v. *City of Thibodaux*, 360 U.S. 25 (1959), a diversity case turning on the interpretation of state eminent domain laws, the Court directed abstention pending a decision by the courts of Louisiana

12. See *Zwickler* v. *Koota*, 389 U.S. 241 (1967), where the Court again pointed out that circumstances other than the opportunity to avoid a constitutional question had arisen in diversity cases and had been determined to require abstention. *Id.*, 249 n.11.

on the legality of a condemnation. To do otherwise, the Court explained, would create the risk of unequal application of important state policy:

> "A Louisiana statute apparently seems to grant such a power. But that statute has never been interpreted, in respect to a situation like that before the judge, by the Louisiana courts and it would not be the first time that the authoritative tribunal has found in a statute less than meets the outsider's eye. Informed local courts may find meaning not discernible to the outsider. The consequence of allowing this to come to pass would be that this case would be the only case in which the Louisiana statute is construed as we would construe it, whereas the rights of all other litigants would be thereafter governed by a decision of the Supreme Court of Louisiana quite different from ours." *Id.*, 30.

Although the city pressed for a decision, the Court reinstated the District Court's stay rather than permit the case to be decided by "a forecast rather than a determination," *Id.*, 27, citing *Railroad Commission* v. *Pullman Co., supra,* 499. Mr. Justice Stewart's statement of the action approved in *Thibodaux,* that

> "In a conscientious effort to do justice the District Court deferred immediate adjudication of this controversy pending authoritative clarification of a controlling state statute of highly doubtful meaning." *Louisiana Power & Light Co.* v. *City of Thibodaux, supra,* 31 (concurring opinion),

makes plain that *Thibodaux* authorizes abstention in cases involving far less significant public policy choices than those that require it here.

And *Thibodaux* clearly requires abstention in cases like this one, where unsettled questions of state law and significant areas of state concern coincide:

> "[Q]uestions may be deserving of state determination because they deal with an area of law which is undergoing significant development, or because the law of other jurisdictions is in sharp conflict, suggesting the need for a fundamental policy choice. . . . If the federal judge is convinced that the question posed to him is close to a matter of central and continuing state concern, then, he may be justified in invoking the doctrine." Note, *Abstention and Certification in Diversity Suits: "Perfection of Means and Confusion of Goals"*, 73 YALE L. J. 850, 867 (1964).

Thus, under the *Thibodaux* rule federal courts, faced with difficult *Erie* problems in determining state law, will postpone[13] decision in order to

> "prevent possible disparity between the federal version of state law and that which would be later fashioned in state court. This expansion of the abstention doctrine was a logical extension of the principle underlying *Erie* that federal courts must defer to state courts for the formulation of state law." Note, *Inter-jurisdictional Certification: Beyond Abstention Toward Cooperative Judicial Federalism*, 111 U.PA. L. REV. 344, 346 (1963).

See also, Lillich & Mundy, *Federal Court Certification of Doubtful State Law Questions*, 18 U.C.L.A. L. REV. 888, 890 (1971); Note, *Louisiana Power & Light* v. *Thibodaux:*

13. Abstention does not involve the relinquishment of jurisdiction: "This course does not constitute abnegation of judicial duty. On the contrary, it is a wise and productive discharge of it. There is only postponement of decision for its best fruition. Eventually the District Court will award compensation if the taking is sustained. If for some reason a declaratory judgment is not promptly sought from the state courts and obtained within a reasonable time, the District Court, having retained complete control of the litigation, will doubtless assert it to decide also the question of the meaning of the state statute." *Louisiana Power & Light Co.* v. *City of Thibodaux*, *supra*, 29.

The Abstention Doctrine Expanded, 69 YALE L.J. 643, 652 (1960).

It is recognized, moreover, that *Thibodaux* sharply curtailed the force of *Meredith* v. *Winter Haven,* 320 U.S. 228 (1943). *Meredith* was a suit brought by municipal bondholders to prevent the city which issued the bonds from retiring them without making certain interest payments. The Fifth Circuit viewed the state law as unclear and ordered the case dismissed without prejudice to a state court action. This Court reversed, holding that:

> "the difficulties of ascertaining what the state courts may hereafter determine the state law to be do not in themselves afford a sufficient ground for a federal court to decline to exercise its jurisdiction. . . ." *Id.,* 234.

Commentators have questioned the strength of *Meredith* after *Thibodaux,* since

> "[I]t is questionable whether the city's condemnation of property involved in *Thibodaux* was any more closely related to local sovereignty or any more sensitive as a subject of federal-state conflict than the city's program for retiring its bonded indebtedness involved in *Meredith.*" Note, *Judicial Abstention from the Exercise of Federal Jurisdiction,* 59 COLUM. L. REV. 749, 764 (1959).

See also, Gowan & Izlar, *Federal Court Abstention in Diversity of Citizenship Litigation,* 43 TEXAS L. REV. 194, 204 n.62 (1964); Note, *Federal Abstention and its Relation to the Erie Doctrine,* 38 TEMP. L. Q. 72, 76-78 (1964). Even the reputedly strict rule of *Meredith,* later modified in *Thibodaux,* was expressly qualified by the Court's recognition that federal courts ought not to decide questions

purely involving state policy where adequate relief is available in the state system. 320 U.S. at 235-36.[14] In *Meredith*, in any event, abstention was improper since the main state law issue had previously been ruled on, in contrast to the instant case.

In *Thibodaux*, however, there were no Louisiana precedents to guide the federal court, and the lower court's stay was affirmed in that light. What amount of uncertainty in state law calls for abstention is not established, but it is clear that an entire absence of decisions, as here, certainly meets the test. See Note, *supra*, 69 YALE L.J. at 652.

B. This case requires decision of an important issue of Florida's public policy.

The controlling issue in this case involves a serious public policy choice. Whether Florida wishes to break with the common law rule (see Point III, *infra*) and adopt the *Diamond* rule, which has only been accepted in a single state, requires consideration of numerous policy implications. A rule which will enrich Florida corporations with windfall recoveries of unlawful profits made by their own insiders—and indeed by outsiders as well—could create greater conflicts of interest than it seeks to reduce.

Chief Judge Friendly remarked on the paramount state interest in this area in another case which also concerned the duties of corporate fiduciaries and those who act with them:

> "Here we are forced to decide a question of New York law, of enormous importance to all New York corporations and their stockholders, on which there is hardly enough New York authority for a really informed prediction what the New York Court of

14. Accord: *Burford* v. *Sun Oil Co.*, 319 U.S. 315 (1943); *Railroad Commission* v. *Rowan & Nichols Oil Co.*, 310 U.S. 573 (1940).

> Appeals would decide on the facts here presented..." *Essex Universal Corp.* v. *Yates,* 305 F. 2d 572, 580 (CA2 1962) (concurring opinion).

And he urged a decision which would have the least possible impact on the unsettled law of the state and thereby "leave the development of doctrine in the area to the State, which has primary concern for it," *id.,* 582. Notably, Judge Friendly remarked that the difficulty of determining such uncertain state-law policies of "enormous importance" to the state of incorporation had

> "led at least one state to authorize its courts to answer questions about its law that a Federal court may ask." *Id.,* 580 (footnote omitted).

And he cited the Florida provisions, FLA. STAT. ANN. §§ 25.031, 25.032 (1961), which might have been used in this case, but were not.

Very recently, in *Kaiser Steel Corp.* v. *W. S. Ranch Co.,* 391 U. S. 593 (1968), this Court unanimously reversed without argument the action of two lower courts in refusing to abstain pending decision by state courts. *Kaiser* involved the right of a private business to condemn land to gain access to water. That issue, this Court said:

> "is one of vital concern in the arid State of New Mexico, where water is one of the most valuable natural resources. The question, moreover, is a truly novel one. The question will eventually have to be resolved by the New Mexico courts, and since a declaratory judgment action is actually pending there, in all likelihood that resolution will be forthcoming soon. Sound judicial administration requires that the parties in this case be given the benefit of the same rule of law which will apply to all other businesses and landowners concerned with the use of this vital state resource." *Id.,* 594.

Judge Brown, in the Court of Appeals in *Kaiser*, had urged his brethren to abstain, stressing that *Meredith* v. *Winter Haven, supra,* did not compel federal courts to speculate unnecessarily on what the state law was:

> "Thus, *Meredith* v. *City of Winter Haven,* [*supra*], is not, as is so often supposed, an absolute that under every and all circumstances a federal court in a diversity case has to plow through without calling on the state tribunals for aid in the divination of serious and troublesome state problems. Too much has gone on—indeed too much water has gone over the dam—for any such reading to be compelled. Putting to one side *Thibodaux,* in which the Court of Appeals was reversed for failure to abstain for state court determination in a diversity case, the Supreme Court's repeated use of the Florida *Clay* type certification procedure demonstrates that the policy reflected in *Winter Haven* is not a road block. It is simply one of the factors to be assayed." *W. S. Ranch Co.* v. *Kaiser Steel Corp.,* 388 F.2d 257, 263-64 (CA10 1968) (concurring and dissenting opinion; footnotes omitted).

To illustrate his point, Judge Brown cited numerous instances when federal courts had gone wrong in forecasting state law:

> "[R]eal injustice is done to litigants and, worse, more damage is done to the states' jurisprudence and its policies by a headstrong, resolute, inflexible determination on the part of a federal court to barge ahead in a sort of ascetic, misguided *Winter Haven* impulse, than will likely result from the slight delay occasioned by invoking state adjudication of the controlling issues. For the simple fact is that more and more, more federal courts are being overruled by more state courts on local issues upon which such federal courts have undertaken to read the *Erie* signs in the quest of the *Winter Haven* grail.

> "Texas, for example, continues on its path of independence in a number of instances not the least of which was the Fifth Circuit's *Delaney* prediction itself. But, this is not an infirmity of the Fifth Circuit alone. And the experience in Florida demonstrates that state court reversals of Federal appellate decisions occur both in appeals of state cases and on *Clay* certification . . . to the Supreme Court of Florida, the latter with some spectacular results." *Id.*, 264-65 (footnotes omitted).

The Florida decisions led this Judge to conclude that

> "No amount of prescience, including that thought by some to come from a Federal Commission, enables a non-Florida Judge authoritatively to determine Florida policy." *Id.*, 265 n.15.

On certiorari this Court took the course urged by Judge Brown and ordered abstention in *Kaiser*, even though the petitioner had begun its state court action only after it lost in the Tenth Circuit, 388 F.2d at 266. That suit then proceeded, and the state supreme court declared state law to be exactly contrary to the Tenth Circuit's view, *Kaiser Steel Corp.* v. *W. S. Ranch Co.*, 81 N.M. 414, 467 P.2d 986 (1970), thereby preventing a serious injustice.

Merely because, as here, a clash of private commercial interests raises the question does not affect the need to abstain. *Kaiser Steel Corp.* v. *W. S. Ranch Co., supra.* Nor can respondents assert the policy of diversity jurisdiction of preventing prejudice in state courts against out-of-state litigants, since the interest they represent is a Florida corporation. See also Liebenthal, *A Dialogue on England: The England Case, Its Effect on the Abstention Doctrine, and Some Suggested Solutions*, 18 W. RES. L. REV. 157, 180 (1966). And plainly this case involves an issue crucial to the operation of all Florida corporations, in an

area where significant public policy choices have to be made by Florida, and where the law of New York has sharply broken from precedent. Thus, abstention was required.

C. Certification fulfills all the purposes of abstention.

But this case does not even require the usual abstention procedures. The question could easily have been certified direct to the Supreme Court of Florida. Under this procedure the federal court states the issue of law and its factual background in a certificate to the Florida court. The parties to the federal action brief and argue the issue, and the Florida court transmits its answer to the federal court.[15] Such course differs in principle from abstention:

> "It would not seem . . . that the certification procedure is in effect a variation of abstention. . . . The federal courts by taking advantage of a certification procedure do not abnegate their responsibility to decide a diversity case. . . .
>
> "The certification procedure is analogous to a situation in which a federal court temporarily abstains because another case between different parties involving precisely the same issues of state law is pending in the state appellate courts. Certainly this would be proper in a diversity case. . . ." Gowen & Izlar, *supra*, 43 TEXAS L. REV. at 209-10 (footnote omitted).

By certifying an issue, the federal court maintains full control of the litigation:

> "[T]he federal court would not be reduced, in a diversity case, to a 'sterile monitor,' for it would be the basic instrument of the resolution of the entire case in specifying the state law question within the framework of the relevant facts and legal issues to the state's highest authority." Liebenthal, *supra*, 18 W. RES. L. REV. at 201.

15. See FLA. APP. RULES, R. 4.61 (1967); see "Statutes Involved", *supra*, pp. 3-5.

Thus certification permits active cooperation between the state and federal court:

> "Judicial cooperation [under abstention] exists only in the sense that a federal court has deferred to a state court. In inter-jurisdictional certification, however, the federal court actively participates in the resolution of the entire case by framing the state law question, specifying relevant facts and legal issues, and certifying directly to the state's highest court." Note, *supra,* 111 U. PA. L. REV. at 350.

See also Kaplan, *Certification of Questions from Federal Appellate Courts to the Florida Supreme Court and its Impact on the Abstention Doctrine,* 16 U. MIAMI L. REV. 413, 432 (1963).

None of the valid purposes of abstention is hindered by certification:

> "Thus, inter-jurisdictional certification . . . not only achieves the objectives of abstention—to prevent federal invasion of the state law-making function and to avoid needless federal-state friction—, but also represents a more perfect attempt at cooperative judicial federalism, since concern for state sovereignty is implemented through a more efficient and simpler proceeding." Note, *supra,* 111 U. PA. L. REV. at 350.

Certification equips federal courts with the best means to "search for and apply the entire body of substantive law governing an identical situation in the state courts," see *Ruhlin* v. *New York Life Insurance Co.,* 304 U.S. 202, 209 (1938), and to "ascertain from all the available data what the state law is and apply it," see *West* v. *American Telephone & Telegraph Co.,* 311 U.S. 223, 237 (1940):

> "In the Diogenes-like search for 'state law', the federal courts have resorted to the decisions of interappellate courts and even the decisions at nisi

> prius courts. Quite obviously such decisions may be questionable, ill-considered and possibly may not represent the 'state law.' The solution offered by the Florida legislation would obviate resorting to unauthoritative sources to determine the law of the state, and would solve the problem of the search for controlling precedents where none, in fact, exists." Vestal, *The Certified Question of Law,* 36 Iowa L. Rev. 629, 644-45 (1951).

Professor Kurland states that certification offers the "greatest promise" of ensuring equal application of state law:[16]

> "The fourth possibility, offering the greatest promise, is to have the federal intermediate appellate court certify the troublesome question of state law to the state high court for resolution. . . . In this manner, the court best equipped to answer the state law questions could do so in a definitive manner, without the expense of time and resources demanded by a stay of the federal court proceeding pending a declaratory judgment action in the state court. . . . [T]he equality of treatment which the Erie rule was aimed to accomplish would be better assured." Kurland, *Mr. Justice Frankfurter, The Supreme Court and the Erie Doctrine in Diversity Cases,* 67 Yale L. J. 187, 214 (1957).

See also, Note, *Consequences of Abstention by a Federal Court,* 73 Harv. L. Rev. 1358, 1368 (1960).

D. Certification presents none of the practical difficulties of abstention.

The practical objections to abstention are cured by certification. Abstention may deny a party the right to have

16. Another writer concludes concisely that certification solves *Erie* problems

> "by making *certain* the state law which the federal court is to apply." Note, *Federal Jurisdiction—Abstention—Inter-Sovereign Certification,* 48 Iowa L. Rev. 185, 193 (1962) (italics original).

the facts found by a federal court. *England* v. *Louisiana State Board of Medical Examiners,* 375 U.S. 411, 416-17 (1964). But if the state court rules on facts found or stated by a federal court, such objection is obviated:

> "Although a certification procedure is used, it is in the federal court that the fact determinations are made, and it is in there that the law derived from the state court in its certified answer will be applied." Gowen & Izlar, *supra,* 43 TEXAS L. REV. at 210.

See also Currie, *The Federal Courts and the American Law Institute,* 36 U. CHI. L. REV. 310, 317 (1969), Note, *supra,* 73 YALE L. J. at 868-69. The purpose of diversity jurisdiction is fully preserved, although its burdens are markedly diminished:

> "[D]iversity jurisdiction is intended to create only an alternative forum to ensure evenhanded application of state law and unbiased fact finding—by definition not involved in certification since the certificate establishes the factual situation—, rather than to provide a means of avoiding state court interpretation of state law." Note, *supra,* 111 U. PA. L. REV. at 359.

Delay and expense that abstention imposes upon litigants, a matter of concern to this court, see *Baggett* v. *Bullitt,* 377 U.S. 360, 379 (1964); *County of Allegheny* v. *Frank Mashuda Co.,* 360 U.S. 185, 196 (1959), do not follow from certification. The Florida procedure has been described as "[p]robably the best solution to the delay problem", Kurland, *Toward a Co-operative Judicial Federalism: The Federal Court Abstention Doctrine,* 24 F.R.D. 481, 489 (1960). See also H. M. HART & H. WECHSLER, THE FEDERAL COURTS AND THE FEDERAL SYSTEM 1006 (2d ed. 1973).

Since certification has none of the practical disadvantages of abstention, it is called for even when abstention might not be appropriate.

> "The Florida certification device, on the other hand, allows litigants to skirt the lower state courts entirely and to obtain a judgment directly from the highest state court in answer to propounded questions of state law, a procedure which may result in considerable savings of time and expense. . . . Given the speed, authority, and economy possible using certification procedures, abstention under these procedures could tolerably range a far wider scale of state law questions than abstention implemented by declaratory judgment." Note, *supra,* 73 YALE L. J. at 867-69 (footnotes omitted).

See also, Lillich & Mundy, *supra,* 18 U.C.L.A. L. REV. at 908-09; Liebenthal, *supra,* 18 W. RES. L. REV. at 201.

Under the Florida procedure, moreover, the question is resolved in an adversary proceeding with the issues sharply focused and devoid of abstraction. *Id.,* 352; see also, Lillich & Mundy, *supra,* 18 U.C.L.A. L. REV. at 901-02, 904-05; Liebenthal, *supra,* 18 W. RES. L. REV. at 202-03.

E. There is a consensus that certification accords with modern principles of judicial administration.

The National Conference of Commissioners on Uniform State Laws has recommended, and the American Bar Association has approved, a proposed Uniform Rule for the certification of questions of law between jurisdictions.[17] The

17. UNIFORM CERTIFICATION OF QUESTIONS OF LAW [ACT] [RULE], approved and recommended for enactment in all the states by the National Conference of Commissioners on Uniform State Laws, in its conference of July 31 through August 5, 1967, and approved by the American Bar Association at its meeting of August 9, 1967.

accompanying note states that the procedure is specifically addressed to the "very difficult" and "awkward" problem, under *Erie R. R.* v. *Tompkins, supra,* of ascertaining "state law when the state judiciary has not spoken definitively on the matter. The federal courts have been forced to guess what the state law is." *Id.,* 3. Certification is said to be

> "a more rapid method than the use of the abstention doctrine and seems to be a much more orderly way of handling the problem." *Id.*

The note remarks on the frequent use by federal courts of the Florida certification procedure. It urges adoption of a uniform rule, to encourage use of certification:

> "[I]t would seem to be eminently desirable that uniformity be achieved in this area. Uniformity would make probable the greater use of certification." *Id.,* 5.

The proposed Uniform Rule, "patterned in large measure on Florida Appellate Rule 4.61", *id.,* 3 n.2, broadly authorizes certification whenever there are questions of state law "which may be determinative of the cause then pending in the certifying court and as to which it appears to the certifying court there is no controlling precedent . . ." *Id.,* 6, § 1.

It is thus difficult to see why the majority below rejected certification and avoided a decision by Florida of the important public policy issue involved. It is especially inexplicable in light of the fact that one member, and the only judge, on the panel of six lawyers who acted for the National Conference of Commissioners on Uniform State Laws in preparing the Uniform Rule was Circuit Judge Waterman, the author of the majority opinion below.[18]

18. *Id.,* 2.

The American Law Institute has also voted its approval of a proposed codification of certification principles. Like the Uniform Rule, it authorizes certification in a broad range of circumstances.[19]

F. This Court has encouraged use of the enlightened Florida certification procedure.

Recognizing its advantages, this Court has itself employed the Florida procedure three times to date. The Court first did so in *Clay* v. *Sun Insurance Office, Ltd.*, 363 U.S. 207 (1960). Speaking for the Court, Justice Frankfurter praised the procedure:

> "The Florida Legislature, with rare foresight, has dealt with the problem of authoritatively determining unresolved state law involved in federal litiga-

19. ALI, STUDY OF THE DIVISION OF JURISDICTION BETWEEN STATE AND FEDERAL COURTS, TENTATIVE DRAFT No. 6 § 1371(e), at 39 (1968). The proposal provides, in full:

> "(e) A court of the United States may certify to the highest court of a state a question of State law, if (1) the State has established a procedure by which its highest court may answer questions certified from such court of the United States; (2) the question of State law may be controlling in the action and cannot be satisfactorily determined in the light of the State authorities; and (3) the court expressly finds that certification will not cause undue delay or be prejudicial to the parties." *Id.*

The annexed commentary summarizes the advantages of certification over the usual abstention process:

> "Since the question will be certified to the highest state court, many of the delays incident to ordinary abstention orders, which require instituting a declaratory judgment action in a state court and prosecuting it through the state courts, may be avoided. Furthermore, the form of the question certified and the record sent to the state court with the certification are always under the control of the certifying federal court which can better assure that the right question will be answered on the right facts." *Id.*, 214.

> tion by a statute which permits a federal court to certify such a doubtful question of state law to the Supreme Court of Florida for its decision. Fla. Stat. Ann., 1957, § 25.031." *Id.*, 212 (footnote omitted).

Again in *Dresner* v. *City of Tallahassee*, 375 U. S. 136 (1963), and in *Aldrich* v. *Aldrich*, 375 U.S. 75 (1963), the Court used the same means to determine Florida law.[20] Mr. Justice Douglas, concurring in *England* v. *Louisiana State Board of Medical Examiners, supra*, mentioned certification as a procedure to be encouraged to "lighten [the] requirements," *id.*, 432, of abstention:

> "Another alternative is for the District Court to follow the certificate route, where one is available. . . . We use [the Florida] procedure on Florida state law perplexities. . . . We cannot require the States to provide such a procedure; but by asserting the independence of the federal courts and insisting on prompt adjudications we will encourage its use." *Id.*, 433-34.

The Second Circuit, however, sacrificing both comity and certainty, needlessly prevented an authoritative ruling and boldly undertook to decide for Florida "a problem presenting fundamental and serious questions of state policy with only fragmentary case materials with

20. *Clay* was decided on the merits after the certified questions were answered, *Clay* v. *Sun Ins. Office, Ltd.*, 377 U.S. 179 (1964). The answers of the Supreme Court of Florida in *Dresner* enabled the Court to dismiss the writ of certiorari as improvidently granted, *Dresner* v. *City of Tallahassee*, 378 U.S. 539 (1964), and in *Aldrich* the Court reversed on the basis of the answers:

> "Given the answers of the Florida court, it becomes plain that the judgment of the Supreme Court of Appeals of West Virginia, based as it was on a misapprehension regarding the law of a sister State, cannot stand." *Aldrich* v. *Aldrich*, 378 U.S. 540, 543 (1964).

which to work," see *W. S. Ranch Co.* v. *Kaiser Steel Corp., supra,* 388 F.2d at 265 n.15. So doing, it disregarded this Court's decisions requiring abstention and specifically approving the use of the certification procedure. The lower court's rejection of that procedure, without any explanation and over firm dissent, requires review to decide the recurring question of when certification is required. Lehman respectfully suggests that in a similar context Justice Holmes correctly stated the merits of certification, saying that

> "I think that such questions are to be encouraged as a mode of disposing of cases in the least cumbersome and most expeditious way." *Chicago, B. & Q. Ry.* v. *Williams,* 214 U.S. 492, 495-96 (1909) (dissenting opinion).

POINT II

The Decision of the Court of Appeals Conflicts With Decisions in Other Circuits.

The Court of Appeals for the Fifth Circuit frequently uses the Florida certification procedure, as this Court has done, to determine state law. One can thus confidently say that, if this case had arisen in the Fifth Circuit, under that court's settled policy the law would have been determined by the Supreme Court of Florida rather than by the strained "prediction" of two judges below, based on New York law.[21]

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21. The Fifth Circuit routinely uses certification in diversity cases. See, *e.g., Gordon* v. *John Deere Co.,* 451 F.2d 234 (CA5 1971) (retroactivity of long-arm statute); *Allen* v. *Estate of Carman,* 446 F.2d 1276 (CA5 1971) (exclusiveness of workmen's compensation remedy; out-of-state contacts); *A. R. Moyer, Inc.* v. *Graham,* 443 F.2d 434 (CA5 1971) (liability of architects and engineers to con-

In *Hopkins* v. *Lockheed Aircraft Corp.*, 394 F.2d 656 (CA5 1958), upon receipt of the answer from the Supreme Court of Florida, the Fifth Circuit strongly endorsed certification in cases, like this one, requiring difficult policy choices in an area of developing law:

> "The difficulty of this problem transcended that of our usual *Erie* travail. This was so for a number of reasons. The local materials with which to work were meagre. Additionally, there had been elsewhere a considerable change in the outlook on choice of law concepts and, most important, the problem was not so much of trying to ascertain what had been held, as it was divining the policy considerations which the Supreme Court of Florida would now embrace. For policy it surely is.
>
> ". . . For a Federal Court to have attempted to resolve the question on its own would have been fraught with great hazard both to litigants and the law. . . .
>
> "Thus where *Erie* often compels the most speculative anticipation on matters not yet decided, Florida's procedure gives a clear, positive final, decisive answer. . . . It is Florida law binding on us as we perform our *Erie* role.

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tractor for delays due to negligence); *Boyd* v. *Bowman*, 443 F.2d 848 (CA5 1971) (automobile insurance policy coverage); *Trail Builders Supply Co.* v. *Reagan*, 409 F.2d 1059 (CA5 1969) (liability of employer to indemnify third party despite exclusiveness of workmen's compensation remedy as to employee); *Gaston* v. *Pittman*, 405 F.2d 869 (CA5 1969) (tort liability of husband to wife after divorce); *Martinez* v. *Rodriquez*, 394 F.2d 156 (CA5 1968) (defense of mother's contributory negligence to father's suit for wrongful death of child); *Life Insurance Co. of Virginia* v. *Shifflet*, 370 F.2d 555 (CA5 1967) (defense based on negligent misrepresentations in suit on life insurance policy); *Hopkins* v. *Lockheed Aircraft Corp.*, 358 F.2d 347 (CA5 1966) (applicability of state limitation on wrongful death recovery; out-of-state contacts); *Green* v. *Am. Tobacco Co.*, 304 F.2d 70 (CA5 1962) (warranty liability of cigaret manufacturer for death due to cancer); cf. *Moragne* v. *States Marine Lines, Inc.*, 409 F.2d 32 (CA5 1969) (cause of action based on unseaworthiness under wrongful death act).

> "In a workable, administratively efficient and expeditious process all doubt is eliminated, all guess work removed." *Id.*, 656-57 (Footnotes omitted).

In other cases the Fifth Circuit has praised the procedure for saving it "from committing a serious error as to the law of Florida which might have resulted in a grave miscarriage of justice". *Green* v. *American Tobacco Co.*, 325 F.2d 673, 674 (CA5 1963).[22] The Fifth Circuit expressly understands and applies this Court's ruling in *Kaiser Steel Corp.* v. *W. S. Ranch Co., supra,* as authority approving its use of certification. *Martinez* v. *Rodriquez,* 410 F.2d 729, 731 n.5 (CA5 1969).

Unless this Court now intervenes, the clear conflict between the Second and Fifth Circuits and other circuits[23] in

22. See also *United Services Life Ins. Co.* v. *Delancy,* 328 F.2d 483, 486 (CA5 1964), listing several instances in which certification saved the Fifth Circuit from erroneously declaring Florida law.

23. The First Circuit has employed the New Hampshire certification procedure to determine the merits of a statutory defense to a tort action. See, *Ford* v. *Black Mountain Tramways, Inc.*, 110 N.H. 20, 259 A.2d 129 (1969). The Maine certification procedure, available to federal district courts, has been used by the District Court in Maine. See, *Pierce* v. *Secretary,* 254 A.2d 46 (Me. 1969) (validity of common law marriage); In re *Richards,* 223 A.2d 827 (Me. 1966) (certified questions not answered where facts unclear); *Norton* v. *Benjamin,* 220 A.2d 248 (Me. 1966) (bar of general release to indemnity claim in tort action). The American Law Institute Proposal to codify the use of certification for federal courts was adopted on the motion of District Judge Gignoux, see ALI PROCEEDINGS 371-88 (1966).

See also, In re *Elliott,* 74 Wash. 2d 600, 446 P.2d 347 (1968), where the Supreme Court of Washington replied to a certified question from the District Court for the Western District of Washington concerning disposition of life insurance proceeds in insolvency; *Irion* v. *Glens Falls Ins. Co.*, 154 Mont. 156, 461 P.2d 199 (1969), where the Supreme Court of Montana answered a question certified by the District Court for the District of Montana relating to ownership of

the application of this useful procedure will endure. The question is important to the fair and efficient administration of the federal judicial system and will recur in numerous cases to which this Court will be unable to give separate attention. The issue thus requires intervention by writ of certiorari.

POINT III

The court below wrongly decided an important issue of Florida law in disregard of its duties under Erie R.R. *v.* Tompkins, 304 U.S. 64 (1938).

The decision below, as Judge Kaufman's dissent recognized, takes unauthorized liberties with the Florida law. Generally, the "common law rule precludes corporate recovery of profits made by insiders on dealings in the corporation's stock." Note, *Inside Information as a Corporate Asset,* 1970 WIS. L. REV. 576, 577 (1970). No Florida decisions support the proposition that confidential information about a corporation, which that corporation could not lawfully use to gain a profit by selling stock, is an "asset" of the company for use of which company fiduciaries are accountable. Far less does Florida law hold that *any* person who profits from such information, in the absence of any sort of confidential relationship, is accountable to the corporation as a "fiduciary". And *a fortiori* there is no rule that persons who merely transmit such information are liable for some third party's profits.

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an automobile involved in a collision; *cf., Almarez* v. *Carpenter,* 477 P.2d 792 (Colo. 1970), where the Supreme Court of Colorado answered questions of state procedure which arose in a federal question case and were certified by the District Court for the District of Colorado.

There is no such rule even in New York. *Diamond*, a decision "unique both in its reasoning and conclusion," Note, *Common Law Fiduciary Principles Applied in Holding Directors Liable to Corporation for Profits from Corporate Stock Sales Made Because of Inside Information*, 37 FORDHAM L. REV. 477, 478 (1969), "discarded the long standing common law rule that precluded corporate recovery", Note, *supra*, 1970 WIS. L. REV. at 578, but only as to fiduciaries of the corporation. In *Diamond* the New York Court of Appeals said the question before it was

> "whether *officers and directors* may be held accountable to *their corporation* for *gains realized by them* from transactions in the company's stock as a result of their use of material inside information." *Diamond* v. *Oreamuno*, *supra*, 496 (emphasis supplied).

The court thus spoke only of officers and directors. Since Lehman was not an officer or director of Lum's, since it was not an investment advisor or banker to Lum's, and since it had no relationship with Lum's which could be called confidential, there is no basis for calling it a "fiduciary" in order to extract a windfall recovery.

Moreover, Lehman made no profits. *Diamond* itself was dismissed on the *pleadings* against other directors who connived in the sales of stock but made no profits themselves, as the court below realized.[24] Thus, under New York law even fiduciaries are not liable if they make no profits, and Lehman is doubly exempt.

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24. The court below passed over this point, saying that the defendants here were "furthering" (19A n.6) the sales, but it is hard to see how a director could better encourage sales by a fellow director than by nondisclosure and ratification, and it is wholly unclear why such action would not constitute a breach of fiduciary duty. The reason for the exemption of the other directors in *Diamond* is plain: if there are no profits, there is no liability.

Principles derived from Florida cases refute the claims herein. Even where a confidential relationship exists, Florida has only imposed liability for use of information which the entrustor could legally employ for his own gain.[25] Indeed, before *Diamond*, "no common law judicial authority existed," Note, *supra*, 37 FORDHAM L. REV. at 478, for corporate recovery of wrongful gains. Nothing in any Florida decision suggests that Florida is contemplating a rejection of the general rule that

> "[L]iability will not attach if it can be shown that the opportunity *could not be acquired by the corporation* and would not lead to future competition with it. . . . In effect, the corporation will be allowed to recover only when it can be shown that the opportunity *would have been of value to it*." Note, *supra*, 1970 WIS. L. REV. at 581 (emphasis supplied).

The decision below stands this principle on its head. Indeed the cases the majority relies on (21A) instead support Lehman. In *Ohio Oil Co.* v. *Sharp*, 135 F.2d 303 (CA10 1943), the court permitted recovery only on a showing that the business opportunity which the defendant misappropriated had been acquired by his employer in all "good faith", *id.*, 309. And in *Brophy* v. *Cities Service Co.*, 31 Del. Ch. 241, 70 A.2d 5 (1959), which held an insider liable for profits he made by buying stock when he knew the corporation would begin a stock repurchase program, the court took care to note that such corporate purchases were authorized by stat-

25. See, *e.g.*, *Inland Rubber Co.* v. *Helman*, 237 So.2d 291 (Fla. App. 1970) (customers' lists known to former employee); *Whittle* v. *Ellis*, 122 So.2d 237 (Fla. App. 1960) (law practice); *Quinn* v. *Phipps*, *supra* (business opportunity known to agent); *Connelly* v. *Special Road & Bridge District No. 5*, 99 Fla. 456, 126 So. 794 (1930) (same).

ute, *id.*, 7 n.1.[26] These cases reject the idea that a company has an equitable right to profits that it could not rightfully make.

None of the deference given to an interpretation of state law by a judge trained in the local jurisprudence is due to the majority opinion below, for Second Circuit judges cannot be viewed as expert in the law of the remote state of Florida. Compare *Bernhardt* v. *Polygraphic Co.*, 350 U.S. 198, 204 (1956), with *Thompson* v. *Magnolia Petroleum Co.*, *supra*, 481. Rather the case presents an extreme instance of disregard of this Court's admonition, especially to be heeded where important matters of public policy are in issue, that where the state decisions portend no radical development, *Bernhardt* v. *Polygraphic Co.*, *supra*, 205, federal judges are without authority to introduce a novel rule. The departure from that principle by the court below calls for this Court's intervention by writ of certiorari.

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26. Thus *Brophy* does not support *Diamond*, for the insider in *Brophy* appropriated a wholly lawful corporate opportunity: "[H]is liability was based not on the use of inside information, but rather on his competition with the corporation in its acquisition of corporate stock." Note, *supra*, 37 FORDHAM L. REV. at 479.

CONCLUSION

For the reasons set forth above, the petition for a writ of certiorari should be granted and the judgment of the Court of Appeals for the Second Circuit reversed.

Respectfully submitted,

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September 6, 1973

APPENDIX

APPENDIX

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

Nos. 70 Civ. 5733, 71 Civ. 1925 and 4218

JOSEPH GILDENHORN, as Guardian for Carol Ann Gildenhorn,

Plaintiff,

v.

LUM'S INC., *et al.*,

Defendants.

ANTONE F. GREGORIO,

Plaintiff,

v.

LUM'S INC., *et al.*,

Defendants.

JACOB SCHEIN and MARVIN H. SCHEIN,

Plaintiffs,

v.

MELVIN CHASEN *et al.*,

Defendants.

December 15, 1971.

TYLER, *District Judge*

Defendants in these consolidated actions have moved to dismiss plaintiffs' complaints upon the ground that they fail to state a claim upon which relief can be granted. Rule 12(b) (6) F.R. Civ.P. Alternatively, all defendants move this court to stay these actions pending a final determina-

tion in *Sanders* v. *Lum's Inc. et al.*, 70 Civ. 5331, a related action pending before this court. Additionally, the individual defendants move that the complaints be dismissed as against them upon the ground that jurisdiction over their persons has not been obtained. Rules 4(e) and 12(b)(2), F.R.Civ.P.[1]

All three of these suits are derivative actions brought on behalf of Lum's Inc. ("Lum's"), a Florida corporation. Jurisdiction is claimed by virtue of diversity of citizenship. The plaintiffs' complaints are predicated on the same facts as *S.E.C.* v. *Lum's et al.*, 70 Civ. 5280, which is also pending before this court. Briefly stated, plaintiffs' claims are based on defendants' alleged misuse of confidential corporate information. The complaints charge that defendant Melvin E. Chasen, aware as president of Lum's that the firm's 1969 earnings would be lower than had been projected, telephoned from his Florida office to defendant Simon, who is employed in the Chicago, Illinois office of defendant Lehman Brothers, Inc., and told him of the earnings' decline. Simon then transmitted the information to Sit, the portfolio manager at defendant IDS New Dimensions Fund ("Dimensions"), whose offices are in Minneapolis, Minnesota. Sit then conveyed the information to defendant Jundt, a manager and analyst for IDS Variable Payment Fund ("Variable"). It is further alleged that Sit and Jundt then caused Variable and Dimensions to sell their entire holdings in Lum's just before the public announcement of the decline in the 1969 earnings caused the stock to drop several points in trading on the New York Stock Exchange.

1. Defendants Sit and Jundt, apparently unaware that I have already granted their prior motions to dismiss by order dated October 25 of this year, once again seek the same relief. As they are no longer defendants in any of these actions, their applications will not be considered.

Plaintiffs make no argument that any of the federal securities acts would support a claim under the facts of this case. They do argue, however, that a claim for which relief can be granted can be made out under the recent decision of the New York Court of Appeals in *Diamond* v. *Oreamuno,* 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969). Briefly stated, that case held that corporate officers who learn of a drop in corporate earnings by virtue of their fiduciary positions and sell their shares of corporate stock before publishing information as to the loss will be liable to the corporation for any profits made thereby. Plaintiffs urge that Chasen be found liable under *Diamond* even though it is not alleged that he sold any Lum's stock belonging to him and that the remaining defendants be so held under either a "tippee" or general conspiracy theory.

Three issues, thus, are presented to this court by these motions, the first being a choice of law problem. The defendants argue that under the applicable choice of law provisions, these cases should be decided by Florida law. Plaintiffs oppose and urge that their complaints be tested by New York law in general and by *Diamond* v. *Oreamuno, supra,* in particular. Assuming that *Diamond* would apply, this court would then have to determine whether the complaints herein can state a claim under the holding of that case. Finally, it must be decided whether the activities of the individual defendants fall within any of the provisions of the New York long-arm statute, CPLR § 302(a), so as to allow out of state service to be effected upon them pursuant to CPLR § 313.

In actions where jurisdiction is predicated on diversity of citizenship, this court must apply the choice of law rules of the State of New York. *Klaxon Co.* v. *Stentor Electric Mfg. Co.,* 313 U. S. 487, 61 S.Ct. 1020, 85 L.Ed. 1477 (1941). New York follows the general choice of law principle that the law of the state of incorporation governs the existence

and extent of corporate fiduciary obligations as well as the liability for violations of such obligations. *Hausman* v. *Buckley,* 299 F.2d 696, 703 (2d Cir., 1962) and cases cited therein; *Norte & Co.* v. *Huffines,* 304 F.Supp. 1096, 1110 n.6 (S.D.N.Y., 1968). This rule was expressed in *Diamond* itself when the court stated that as regards the ". . . duties and obligations of directors and officers and their relation to the corporation and its shareholders . . . [t]he primary source of the law in this area ever remains that of the State which created the corporation." *Diamond* v. *Oreamuno, supra,* at 503, 504, 301 N.Y.S.2d at 85, 248 N.E.2d at 915.

The same result would be reached by the "grouping of contacts" approach to choice of law in tort actions as enunciated in *Babcock* v. *Jackson,* 12 N.Y.2d 473, 240 N.Y.S.2d 743, 191 N.E.2d 279 (1963). Under this approach, a New York court will apply the law of the state of the "strongest contacts with the cause of action." *Stockwell* v. *Reynolds & Co.,* 252 F.Supp. 215, 220 n.3 (S. D.N.Y., 1965). It appears from the pleadings that this case centers in Florida rather than in New York. Chasen, a Florida citizen, allegedly received and communicated the information from Florida. Lum's was incorporated, headquartered, and, at least theoretically, damaged in Florida. Most of the other contacts appear to be scattered about the midwest, the only contact with New York being several transactions over the New York Stock Exchange. Additionally, a New York court would give more weight to the Florida contacts under the "governmental interest" theory of choice of law enunciated in *Tooker* v. *Lopez,* 24 N.Y.2d 569, 301 N.Y.S.2d 519, 249 N.E.2d 394 (1969), because Florida has the paramount interest in defining and enforcing fiduciary obligations owing to corporations incorporated and doing business within its borders. Accord-

ingly, I find that under any conceivable test, a New York court would apply Florida law to this case.

Under present Florida case law, a plaintiff in a derivative action must prove that the corporation has been damaged by the alleged breach of fiduciary trust. Although the highest court in that state has apparently not considered the matter, several District Courts of Appeal have held on various occasions that a complaint which fails ". . . to indicate both wrongful acts and damage to the corporation" must be dismissed. *Palma* v. *Zerbey,* 189 So. 2d 510, 511 (Fla.App., 1966), cert. denied 200 So.2d 814. (and cases cited therein.)

While it is apparently required that the damage to a corporation be alleged, the Florida cases shed no light on the specificity required for pleading corporate damage. Thus, though the Gildenhorn and Gregorio complaints might be insufficient under Florida law for failing to allege any damage to the corporation at all, the Schein complaint, which contains only a bare allegation that Lum's was damaged, might conceivably be held to be sufficient by a Florida court. Furthermore, I am not unmindful of the possibility that, were a Florida court to hear this case, *Diamond* v. *Oreamuno, supra.,* would be argued to it. Because of the possibility that the *Diamond* rationale might be followed in Florida, it is desirable that this court determine whether these complaints state a claim under *Diamond* for which relief can be granted.

It is clear that the complaints in these actions go far beyond the narrow holding of *Diamond.* In that case, the New York Court of Appeals held that a corporate fiduciary is liable for profits which he realizes from a sale of stock motivated by inside information received by him in his corporate position. None of the defendants in these actions fit into this mold. Chasen, as president and chief operating officer of Lum's, was certainly a fiduciary of that corpo-

ration. None of the complaints, however, allege that he did anything more than pass the inside information to defendant Simon, and there are no allegations that Chasen sold any of his Lum's stock or derived any gain, monetary or otherwise, from the sales that ultimately occurred. On the other hand, the mutual fund defendants would have profited if, as alleged, they sold their 83,000 shares of Lum's stock on the basis of Chasen's inside information. It can scarcely be maintained, however, that the mutual fund defendants were officers or directors of Lum's or owed any fiduciary duties whatsoever to that corporation. The broker-dealer defendants fail to come within either of the *Diamond* perimeters as they were not fiduciaries of the corporation and, did not profit by virtue of the sales.

Plaintiffs, of course, urge a more expansive view of *Diamond*. They point to portions of the opinion indicating that the purpose of the holding was to protect the corporation's interest in ". . . maintaining a reputation of integrity, an image of probity, for its management and in insuring the continued public acceptance and marketability of its stock." *Diamond* v. *Oreamuno, supra,* at 499, 301 N.Y.S.2d at 82, 248 N.E.2d at 912. Thus, say plaintiffs, if the purpose of *Diamond* is to maintain a corporation's integrity on the securities exchanges, it should make no difference whether an officer or director sells his own stock or passes the inside information to others who in turn sell their stock and profit thereby. While the harm done to the corporation might be equal in either instance, there is evidence that *Diamond* was not intended to cover the latter situation. As Chief Judge Fuld explained, the purpose of that derivative action was to allow individual shareholders to be ". . . 'private Attorney General[s]' to . . . enforce proper behavior on the part of corporate officials." *Diamond* v. *Oreamuno, supra,* at 503, 301 N.Y.S.2d at 85, 248

N.E.2d at 915. It is implicit that the jurisdiction of these "private attorney generals" would be limited to the corporation in which they are shareholders. It could not, with any logic, be extended in a derivative action to cover outside individuals, corporations, or institutions who are subject to other private and governmental restraints on their behavior. Furthermore, in affirming the dismissal of the *Diamond* complaint against other board members who were alleged to have aided the defendants in concealing their activities, the New York Court of Appeals made it quite clear that *Diamond* extends only to corporate fiduciaries who actually profit by inside information and does not cover aiders and abettors and/or conspirators. In view of the fact that the New York Court of Appeals could not bring itself to find liability for inter-corporate conspirators, I fail to perceive how this court could extend *Diamond* to cover extra-corporate conspirators and tippees. Accordingly, I conclude that with regard to all defendants save Chasen, the complaints herein fail to state a claim for which relief can be granted.

On the other hand, Chasen, as a corporate officer, might well come within the *Diamond* holding. Although it could be plausibly argued that *Diamond* would not apply to Chasen because of the failure to allege that he sold any stock and profited thereby, it might also be maintained that a New York court could find liability in light of the numerous statements in *Diamond* to the effect that the purpose of the holding is to prevent corporate misfeasance. This question, however, need not be reached because service of process upon Chasen was improper.

In diversity actions, this court's jurisdiction is determined by the law of the State of New York. Rule 4(d)(7), F.R.Civ.P. Because Chasen is not a New York resident and was not served in New York, jurisdiction of his person depends on the New York long-arm statute, CPLR

§ 302(a). It is plaintiffs' assertion that jurisdiction was obtained over Chasen because he set in motion events which culminated with the alleged sale of 83,000 shares of Lum's stock over an exchange located in New York. While I am aware that the scope of CPLR § 302(a) has been broadly construed, I fail to see how it can be read to cover the facts in this case.

While it is settled that one can "transact business" within the meaning of CPLR § 302(a) (1) through an agent, *Parke-Bernet Galleries, Inc.* v. *Franklyn,* 26 N.Y.2d 13, 308 N.Y.S.2d 337, 256 N.E.2d 506 (1970), a New York court would decline jurisdiction of a defendant who merely telephones a single order from outside the state. *Katz & Son Billiard Prods.* v. *Correale & Sons,* 20 N.Y.2d 903, 285 N.Y.S.2d 871, 232 N.E.2d 864 (1967). It seems obvious that Chasen, who did not place the order to sell the Lum's stock in question, did not "purposefully" avail himself "of the privilege of conducting activities" within New York, thereby "invoking the benefits and protections of its laws." *Hanson* v. *Denckla,* 357 U.S. 235, 253, 78 S.Ct. 1228, 1240, 2 L.Ed.2d 1283 (1958).

Plaintiffs next argue that the sale of stock over a national exchange in New York was a "tortious act within the state" and that jurisdiction could be found under CPLR § 302(a) (2). While such a sale will confer jurisdiction in some cases, *Cooper* v. *North Jersey Trust Co. of Ridgewood, New Jersey,* 250 F.Supp. 237 (S.D.N.Y., 1965), CPLR § 302(a) (2) can apply only where the non-resident defendant committed the tort in New York. That the alleged tort here may have been completed or "came to rest" in New York will not confer jurisdiction unless the acts or omissions complained of also occurred in New York. *Feathers* v. *McLucas,* 15 N.Y.2d 443, 261 N.Y.S.2d 8, 209 N.E.2d 68 (1965). *Cooper* v. *North Jersey Trust Co. etc.,*

supra, is not inconsistent as the defendants in that case were physically in New York when they allegedly committed the tort there in issue. As it is nowhere alleged that Chasen committed a tortious act in New York, no jurisdiction of his person can be claimed under CPLR § 302(a) (2).

Finally, there can be no jurisdiction under CPLR § 302(a) (3). As the statute clearly states, the tortious act must cause injury to persons or property in New York. Insofar as none of the non-resident plaintiffs in these cases have alleged that any injury occurred in New York, their invocation of this provision is futile.

Defendant Chasen's motion to dismiss is granted on the ground that no jurisdiction was ever obtained of his person. Rule 12(b) (2) F.R.Civ.P. The motions of the remaining defendants to dismiss under Rule 12(b) (6) F.R.Civ.P. are hereby granted. In view of these rulings, defendants' alternative motion for a stay of these actions need not be reached.

Settle orders accordingly.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

70 Civil 5733 HRT

JOSEPH GILDENHORN, as Custodian for CAROL ANN GILDENHORN,

Plaintiff,

against

LUM'S INC., *et al.*,

Defendants.

71 Civil 1925 HRT

ANTONE F. GREGORIO,

Plaintiff,

against

LUM'S, INC., *et al.*,

Defendants.

71 Civil 4218 HRT

JACOB SCHEIN and MARVIN H. SCHEIN,

Plaintiff,

against

MELVIN CHASEN, *et al.*,

Defendants.

Defendants Investors Diversified Services, Inc., IDS New Dimensions Fund, Inc., and Investors Variable Payment

Fund, Inc., having moved to dismiss the complaints and the amended complaint in the above entitled actions under Rule 12(b) of the Federal Rules of Civil Procedure and the defendants Benjamin Simon, Lehman Brothers, Lum's, Inc., and Melvin Chasen having joined in said motion and said motions having come on to be heard before the Honorable Harold R. Tyler, United States District Judge, on November 19, 1971, and the Court having considered the papers submitted on said motions, having heard argument of counsel, and having issued an Opinion dated December 15, 1971 granting said motions, it is hereby

ORDERED that the above entitled actions be and they hereby are dismissed with prejudice, and without costs.

Dated: New York, New York
January 5, 1972

H. R. TYLER, JR.
U.S.D.J.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 81 and 82—September Term, 1972.

(Argued October 17, 1972 Decided May 10, 1973)

Docket Nos. 72-1373, 72-1375

JACOB SCHEIN and MARVIN H. SCHEIN,
Plaintiffs-Appellants,

v.

MELVIN CHASEN, INVESTORS DIVERSIFIED SERVICES, INC., LEHMAN BROTHERS, INVESTORS VARIABLE PAYMENT FUND, INC., BENJAMIN SIMON, IDS NEW DIMENSIONS FUND, INC., EUGENE S. SIT, JAMES R. JUNDT, and LUM'S, INC.,
Defendants-Appellees.

ANTONE F. GREGORIO, individually and as representative of all persons similarly situated as a class under Rule 23, F.R.C.P.,
Plaintiff-Appellant,

v.

LUM'S, INC., MELVIN CHASEN, LEHMAN BROTHERS, BENJAMIN SIMON, INVESTORS DIVERSIFIED SERVICES, INC., EUGENE S. SIT, and JAMES R. JUNDT,
Defendants-Appellees.

Before:

WATERMAN, SMITH and KAUFMAN,
Circuit Judges.

Invoking the diversity jurisdiction of the court, plaintiffs in three cases consolidated below sued derivatively in United States District Court for the Southern District of New York, Tyler, *J.*, alleging that defendants were jointly and severally liable under state corporation law for the profits realized by the defendants Mutual Funds through their trading on the New York Stock Exchange in derivative defendant's stock on the basis of non-public material inside information. An order granting summary judgment was granted to defendants and in two of the consolidated actions the parties have argued appeals.

Reversed and remanded for further proceedings consistent with this opinion.

WATERMAN, *Circuit Judge:*

Plaintiffs-appellants are stockholders in Lum's, Inc., a Florida corporation primarily engaged in restaurant franchising. Invoking the diversity jurisdiction of the court, they sued derivatively in the Southern District of New York alleging that the defendants were jointly and severally liable to Lum's for actionable wrongs which the defendants had committed against Lum's. The individual defendants were Melvin Chasen, a resident of Florida, president of Lum's, Benjamin Simon, a stockbroker employed in Chicago, Ill. by defendant Lehman Brothers, Eugene S. Sit, portfolio manager of defendant IDS New Dimensions Fund, Inc., a Mutual Fund, and James R. Jundt, manager of defendant Investors Variable Payment Fund., Inc., a Mutual Fund. Each of the four individual defendants moved for dismissal on the ground that they had not been validly served under the New York Long Arm Statute (CPLR §§ 313, 302(a)) and that the court below had no personal jurisdiction of them. Sit's and Jundt's motions were granted prior to the filing of the

order appealed from, Chasen's was granted concurrently therewith, and Simon's has apparently not been acted upon.[1] The defendants Lehman Brothers, a partnership engaged in stock brokerage and investment counseling, the three corporations, engaged in managing investment portfolios and in buying and selling the corporate securities of publicly held corporations, Chasen, and Simon, all moved for dismissal on the ground that the complaints failed to state a cause of action under Florida law. Plaintiffs claimed that New York law should govern the rights and liabilities of the parties, and that even if Florida law were the applicable law they should still prevail. Holding that Florida law was the proper state law to apply, Judge Harold R. Tyler, Jr., by written order, *sub nom Gildenhorn* v. *Lum's, Inc.,* opinion reported at 335 F.Supp. 329 (SDNY 1971), granted the motion to dismiss for failure to state a claim upon which relief could be granted.

On this appeal plaintiffs claim only that Judge Tyler erred in dismissing the complaints for failure to state a cause of action.[2] They do not appeal Judge Tyler's order dismissing Chasen as a defendant or his finding that the substantive law of Florida governs the action.[3] Inasmuch

[1] Plaintiffs-appellants have not appealed the order dismissing the actions against Chasen, Sit and Jundt. Simon filed a similar dismissal motion but the trial court did not decide it. Simon was dismissed as a defendant by the court's order dismissing the complaints against all defendants for failure to state a cause of action under 12(b)(6) of the Fed. R. Civ. P. Simon contends on this appeal that irrespective of our action on the lower court's dismissal of the complaints under 12(b)(6), we should dismiss the action against him because he has not been validly served. However, inasmuch as the trial court has not reached this question, we decline to address it on this appeal, and leave its resolution to the trial court upon remand.

[2] In one of the original actions consolidated below, *Gildenhorn* v. *Lum's, Inc.,* 335 F.Supp. 329 (SDNY 1971) a notice of appeal was filed by plaintiff but the parties have not progressed the appeal.

[3] The parties now agree that the substantive law of the State of Florida governs the action for reasons which are stated in Judge Tyler's opinion reported at 335 F.Supp. 329 (SDNY 1971).

as the court is passing only upon the sufficiency of the complaints, we necessarily accept the allegations of the complaints as true. For reasons which follow, we hold that the complaints do state a cause of action and we reverse the judgment below and remand to the district court for further proceedings there in the light of this holding.

The facts alleged in this case fall within the perimeter of the much-discussed problem of unfair trading in corporate securities. In November of 1969 Chasen, who was president and chief operating officer of Lum's addressed a seminar of about sixty members of the securities industry with reference to Lum's earnings prospects for its fiscal year ending July 31, 1970. He informed them that Lum's earnings would be approximately $1.00 to $1.10 per share. On January 5, 1970 he learned that this estimate was too optimistic and that, in fact, Lum's earnings would be only approximately $.76 per share. Three days later, prior to announcing the information to the public, Chasen telephoned Simon in Chicago and told Simon that Lum's would not have as profitable a year as had been expected. He specified to Simon that earnings would be approximately $.76 per share rather than the $1.00 per share which he had earlier announced. Simon knew the information was confidential corporate property which Chasen had not given out publicly. Simon immediately telephoned this information to Sit, an employee of defendant Investors Diversified Services, Inc. (IDS),[4] and Sit immediately telephoned it to Jundt, another employee of IDS. Sit and Jundt managed the stock portfolios of defendant mutual funds Investors Variable Payment Fund, Inc. (Investors) and IDS New Dimensions Fund, Inc. (Dimensions). Upon receiving the

[4] Defendant IDS is a Minnesota corporation licensed to do business in the State of New York. IDS is the distributor and investment advisor for a number of large mutual funds including defendants Investors and Dimensions. Sit and Jundt are employed by IDS to manage the stock portfolios of Investors and Dimensions.

information Sit and Jundt directed the Funds to sell their entire stock holdings in Lum's and, on the morning of January 9, 1970, prior to any public announcement, Investors sold 43,000 shares of Lum's and Dimensions sold 40,000 shares. The sales were executed on the New York Stock Exchange at about 10:30 A.M. at a price of approximately $17.50 per share. At 1:30 P.M. on the same day, the New York Stock Exchange halted further trading in Lum's stock pending a company announcement. At 2:45 P.M. Lum's issued a release which appeared on the Dow Jones News Wire Service and announced that the corporation's projected earnings would be lower than had been anticipated. When trading in Lum's was resumed on Monday, January 12, 1970, volume was heavy and the stock closed at a price of $14.00 per share—$3.50 per share lower than the Funds had realized from the sales of their shares on the previous Friday.

The present defendants in this case are Lehman Brothers, Simon, and the two Mutual Funds. Chasen, Sit, and Jundt have been dismissed as defendants in that they have not been validly served under the New York State Long Arm Statute. Plaintiffs-appellants' theory of recovery is that the participants in this chain of wrongdoing are jointly and severally liable to the corporation under Florida law for misusing corporate information to their own advantage in violation of the duty they owed to Lum's, and that they must account to Lum's for the profits realized by the Mutual Funds. They do not allege in these complaints that defendants have violated any of the federal securities laws,[5] and they concede that the substantive law

[5] Lum's could apparently not prevail as a plaintiff in a Rule 10b-5 action in that it has not traded in its securities on its own account. See *Birnbaum* v. *Newport Steel Corporation*, 193 F.2d 461 (2 Cir. 1952), cert. denied, 343 U.S. 956 (1952). Although there are federal securities law cases pending against defendants in district court, this fact is irrelevant upon this appeal.

of Florida governs the rights and liabilities of the parties. They urge, however, that inasmuch as there are no Florida cases directly in point, the Florida court, if it were deciding the case, would look to other jurisdictions and would take a particular and special interest in the decision of *Diamond* v. *Oreamuno*, 29 A.D.2d 285, 287 N.Y.S.2d 300 (1st Dep't 1968), *aff'd* 24 N.Y.2d 494, 301 N.Y.S.2d 78 (1969), a case which plaintiffs contend supports the position they urge on this appeal.

The first question which our court must consider is whether we may look to the New York decision of *Diamond*, *supra*, as persuasive authority. Ideally, the federal court sitting in a diversity action applies the applicable state law as it has been enunciated by the highest court in the state. *Erie R. Co.* v. *Tompkins*, 304 U.S. 64 (1938); *Hausman* v. *Buckley*, 299 F.2d 696 (2 Cir. 1962), *cert. denied*, 369 U.S. 885 (1962). However, in the absence of a clearly enunciated state rule, the federal court may turn to the law of other jurisdictions for assistance in determining how the state court would most likely decide the case if the state court were presented with the questions being litigated in the federal court. *Baxter* v. *Lancer Industries, Inc.*, 213 F.Supp. 92 (EDNY 1963), *app. denied*, 324 F.2d 286 (2 Cir. 1963); *Locke Manufacturing Companies* v. *United States*, 237 F.Supp. 80 (D. Conn. 1964). Our foray into the state law of Florida satisfies us that the Florida court has never faced the precise issues which are present in this action. Accordingly, it is both proper and practical for this court to turn for guidance to the body of law of other jurisdictions and particularly to that of New York where the resolution of the issues in the *Diamond* case, decided by the New York Court of Appeals, bears on the issues in the case before us. In doing so, our objective is to interpret *Diamond* as the Florida court would probably interpret it and

to apply *Diamond*, as so interpreted, to the facts presented here.

Diamond v. *Oreamuno, supra,* was a stockholder's derivative action in which a shareholder of Management Assistance, Inc. (MAI) charged that two of the defendants—Oreamuno, chairman of the board of directors, and Gonzales, its president and a member of the board, had used inside information acquired by them solely by virtue of their positions with MAI in order to reap large personal profits from the sale of MAI shares, and that these profits rightfully belonged to the corporation. Chief Judge Stanley Fuld, writing for a unanimous court, held that the two directors must account to the corporation for their profits for they had breached their duty to the corporation by using a corporate asset for their own personal advantage.

In this case we are asked to decide whether the *Diamond* holding should extend to reach third parties who, though not officers or directors of the injured corporation, are involved with directors in a common enterprise to misuse confidential corporate information for their own enrichment. Although there is no allegation in the complaints that a prior explicit agreement existed between Chasen and the defendants, it is obvious that the sequence of events detailed in the pleadings, if proved, will substantiate the existence of a common enterprise pursuant to which Chasen was to pass material information to Simon, Simon was to pass it to the Mutual Funds, and the Funds were to capitalize on it by selling Lum's stock prior to the time the material information was announced to and was available to the public. Cf. *American Tobacco Co.* v. *United States,* 328 U.S. 781 (1946); *Interstate Circuit, Inc.* v. *United States,* 306 U.S. 208 (1939); *Norfolk Monument Company* v. *Woodlawn Memorial Gardens, Inc.,* 394 U.S. 700 (1969). Although defendants do not deny that they have been involved in a joint enterprise with Chasen to misuse corpo-

rate property, they argue that the doctrine of *Diamond* is not applicable here and that they cannot be held liable to Lum's because they are not Lum's fiduciaries and have not breached any duty which they owed to Lum's by cashing in on confidential information for their own advantage. Defendants Simon and Lehman Brothers make the further argument that it would be "unfair" to hold them responsible for the profits made by the Mutual Funds in that they (Simon and Lehman Brothers) did not profit personally inasmuch as neither of them traded in Lum's stock.

As a court of equity viewing the case as the Florida court would probably view it, we cannot agree that the "stretch" of *Diamond* does not reach the defendants in this case. We find nothing in the language of *Diamond* to suggest that co-venturers of the director who breaches his duty should not be subject to the same liabilities as those of the director himself for the misuse of corporate information.[6] Indeed, the general rule has always been that "one who knowingly participates in or joins in an enterprise whereby a violation of a fiduciary obligation is effected is liable jointly and severally with the recreant fiduciary." *Oil & Gas Ventures—First 1958 Fund Ltd.* v. *Kung,* 250 F.Supp. 744 (1966); see, *e.g., Jackson* v. *Smith,* 254 U.S. 586, 589 (1921); *Sexton* v. *Sword S.S. Line Inc.,* 118 F.2d 708, 711 (2 Cir. 1941); *Bankers Life and Casualty Co.* v. *Kirtley,* 338 F.2d 1006, 1013 (8 Cir. 1964). If the *Diamond* court had intended to lay down an exception to this well-

[6] We believe Judge Tyler erred in attaching dispositive significance to the fact that in *Diamond,* supra, the complaint was dismissed against certain directors who had only "acquiesced" in the wrong. The defendants-appellees here differ from the dismissed *Diamond* defendants in that the defendants-appellees were actively engaged in furthering the transaction that resulted in the "dumping" of the Lum's stock, rather than just "acquiescing" in it. Furthermore, and even more importantly, *Diamond* was not a "joint venture" case, and there is no discussion in the *Diamond* opinion as to why the complaint was dismissed against the "acquiescing" directors.

known general rule it could have done so in its opinion. Moreover, in the light of the corporate interest which the *Diamond* rule is designed to protect, it is immaterial to the preservation of that interest whether the director trades on his own account in the corporation's stock or whether he passes on the information to outsiders who then trade in the corporation's stock. In either event, so long as the director is involved, the prestige and good will of the corporation may be tarnished by the public revelation that the director has been involved in unethical conduct. *Diamond, supra* at 499; accord, *S.E.C.* v. *Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2 Cir. 1971), *cert. denied*, 404 U.S. 1005, *reh. denied*, 404 U.S. 1064 (1972). Accordingly, it would be self-defeating to limit the reach of *Diamond* to directors and officers of the injured corporation who have so acted while permitting third-party co-venturers of theirs to escape liability to the corporation.

Diamond, the law of the jurisdiction in which the New York Stock Exchange is seated, has the prophylactic effect of providing a disincentive to insider trading. It is clear that this cleansing effect ought to reach third parties who, through a breach of a fiduciary relationship, become traders advantageously possessed of confidental insider knowledge. To immunize such third parties from liability to the damaged corporation would encourage insider "leaks" to outside friends and would defeat *Diamond's* purpose and effect. And, quite properly, damages for fiduciary breaches are recoverable by recourse to state law. Indeed, though the congressional policy is similar, in some cases where federal private and governmental Rule 10b-5 actions are impractical, "immunized outsiders" might escape liability altogether except for the availability of this kind of action bottomed upon the well-recognized liability of a fiduciary to those whose trust in the fiduciary has been tragically

misplaced. In view of the strong desirability of tightening the law of insider trading, we would be remiss indeed if we interpreted *Diamond* as narrowly as defendants would have us interpret it. Moreover, sitting as a court of equity, we have here an obligation to determine where the equities lie among all the litigants, *Diamond, supra* at 498, and, as between the defendants and Lum's, there can be no doubt that it would be inequitable to permit the defendants to keep the rewards of the fraud.[7]

Our view that all the participants in the common enterprise must assume the same risks of liability to the corporation as the offending director is supported by Florida case law dealing with the duty of a fiduciary to his cestui. The Florida courts have held that the duty of a fiduciary not to misuse the property of his cestui extends not only to the "technical fiduciary" but also to others who are placed in a position of trust. *Quinn* v. *Phipps*, 93 Fla. 805, 113 So. 419 (1927). The confidential relationship of a fiduciary as that relationship is spelled out in Florida law extends not only to "technical fiduciaries" but also to others who become "fiduciaries" through the acquisition of confidential information which is "owned" by someone else. See *Quinn* v. *Phipps, supra* at 420-421. When the defendants received their "tip" from Chasen, they were automatically clothed with a duty to Lum's not to use the information for their own selfish advantages. Compare *Brophy* v. *Cities Service Co.*, 31 Del. Ch. 241, 70 A.2d 5 (1949); *Ohio Oil Co.* v. *Sharp*, 135 F.2d 303 (10 Cir. 1943).

[7] This principle has been applied in analogous cases involving violations of the federal securities laws. In more than one instance, the corporation whose stock has been illegally traded has been permitted to recover conditionally in a Rule 10b-5 action because it is more equitable for it to recoup the rewards of the fraud than for the insider who profits by misusing corporate information to keep them. See *Securities and Exchange Commission* v. *Texas Gulf Sulphur*, 446 F.2d at 1308; *S.E.C.* v. *Golconda Mining Company*, 327 F.Supp. 257 (SDNY 1971).

This is firmly grounded in law and the rule is set forth in the American Law Institute's Restatement of Agency 2d § 312 (1958): "A person who, without being privileged to do so, intentionally causes or assists an agent to violate a duty to his principal is subject to liability to the principal." And see Comment c to § 312:

> A person who, with notice that an agent is thereby violating his duty to his principal, receives confidential information from the agent, may be enjoined from disclosing it and required to hold profits received by its use as a constructive trustee. * * * *

Therefore, if plaintiffs can prove their allegations, it would seem that liability of the Mutual Funds to Lum's must necessarily follow. Be that as it may be, however, the defendants Lehman Brothers and Simon contend that it would be inequitable to apply the rule to them because they did not personally profit by trading in Lum's stock and they hold no profits as constructive trustees of that corporation. Nevertheless, Lehman Brothers and Simon obviously misused inside information as much as Diversified and Investors misused it, and therefore we fail to see how equity would be furthered by imposing liability only on the Funds and not on the other participants who supplied the Funds with the inside information. It is well established that the liabilities of persons engaged in a joint enterprise to commit a wrong are both joint and several liabilities and each participant is liable to account for the profits of the other participants. *Marcus* v. *Otis,* 168 F.2d 649 (2 Cir. 1948), *modified,* 169 F.2d 148 (2 Cir. 1948); *Solomon* v. *United States,* 276 F.2d 669 (6 Cir. 1960), *cert. denied,* 364 U.S. 890 (1960), *reh. denied,* 364 U.S. 939 (1961). Accordingly, we hold that it would be proper to hold Lehman Brothers and Simon just as accountable for

the profits made by their tippees Diversified and Investors as the tippees themselves.[8]

Defendants also contend that the complaints are presently insufficient because they fail to allege with sufficient particularity the damages Lum's is claimed to have suffered. This contention is without merit. Although the Gregorio complaint fails to allege any damages to Lum's, the Schein complaint contains a general allegation of damages, and we find nothing in Florida law to require anything more than a general ad damnum allegation.[9]

Defendants also urge that inasmuch as there are private Rule 10b-5 class actions for damages, *e.g., Sanders* v. *Lum's, Inc., et al.*, 70 Civ. 5331 (SDNY) and an administratve suit brought by the Securities and Exchange Commission, *SEC* v. *Lum's, et al.*, 70 Civ. 5280 (SDNY), pending in federal district court, defendants might be subjected to multiple liability if they are forced to remit to Lum's the profits the Mutual Funds made on their January 9 sales. Since appel-

[8] In passing we note decisions dealing with violations of the federal securities laws which involve the imposition of liability on defendants who have occupied statuses similar to the statuses occupied by defendants in this case. Thus, in *Securities and Exchange Commission* v. *Texas Gulf Sulphur*, 446 F.2d at 1308, the same argument raised by Simon and by Lehman Brothers was raised by defendant Darke. This court held that Darke was liable as a tippor for the profits realized by his tippees. Furthermore, "tippee liability," which is analogous to the liability being imposed upon Diversified and Investors, has been established in federal cases involving violations of the securities laws. See *Ross* v. *Licht*, 263 F.Supp. 395 (SDNY 1967); *In the Matter of Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

[9] We find it unnecessary to decide whether the defendants could prevail if *neither* complaint alleged damages to Lum's. We point out, however, that Florida law is not clear on the question and *Diamond* holds specifically that an allegation of damages is not a prerequisite to a recovery. *Diamond* v. *Oreamuno, supra* at 499. The case cited by defendants for the proposition that damages must be alleged (*Palma* v. *Zerbey*, 189 So.2d 510 (Fla.App. 1966), cert. denied, 200 So.2d 814 (Fla. 1967)) is a one paragraph per curiam opinion of a lower Florida court, the Florida District Court of Appeals which, inasmuch as it fails to provide a discussion of the issues, we find to be totally unpersuasive.

lees are fully aware of these federal court actions they are well able to protect themselves from multiple liability.[10]

Preventing those who are privy to confidential inside information from using it to their own advantage has found expression in numerous cases in the federal courts dealing with violations of the federal securities laws. See *Securities and Exchange Commission* v. *Texas Gulf Sulphur,* 401 F.2d 833 (2 Cir. 1968), *cert. denied sub nom. Coates* v. *SEC,* 394 U.S. 976 (1969); *List* v. *Fashion Park, Inc.,* 340 F.2d 457 (2 Cir. 1965), *cert. denied,* 382 U.S. 811 (1965); *Wohl* v. *Blair & Co.,* 50 F.R.D. 89 (SDNY 1970); *Ross* v. *Licht,* 263 F.Supp. 395 (SDNY 1967); *Speed* v. *Transamerica Corp.,* 99 F.Supp. 808, 828-829 (D.Del. 1951), *aff'd* 235 F.2d 369 (3 Cir. 1956).

Accordingly, as to those persons found to be within the jurisdiction of the court, we reverse the order appealed from and remand the case for such further proceedings below as may be consistent with the contents of this opinion.

KAUFMAN, *Circuit Judge* (dissenting):

In my view, it is no longer debatable that trading on inside information merits universal condemnation.[1] The undesirable nature of "insider trading" is reflected in the prophylactic provisions of Section 16(b) of the Securities Exchange Act of 1934 and the more general antifraud principles of Section 10b of that Act. I fully agree with Judges Waterman and Smith that one with access to material inside information concerning a corporation's affairs who

[10] See, for example, the method employed in *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.,* 312 F.Supp. 77, 93 (SDNY 1970), *aff'd in part, rev'd in part,* 446 F.2d 1301 (2 Cir. 1971), cert. denied, 404 U.S. 1005 (1971), reh. denied, 404 U.S. 1064 (1971).

[1] But for a contrary view, *see* H. Manne, Insider Trading and the Stock Market (1966).

knowingly purchases or sells that corporation's shares before this information has become publicly available takes unfair advantage of unknowledgeable parties to the transaction. Indeed, the factual claims contained in the complaints before us have led to two federal actions—an SEC injunctive action and a private class action under rule 10b-5—now pending in the District Court for the Southern District of New York. But the adage that hard facts make bad law is about to come true here, despite Judge, later Justice, Cardozo's warning that judges are not free agents roaming at will to create law to fit the facts. *See* The Nature of the Judicial Process 141 (1921). In the absence of any viable precedent upon which to base the totally new concept of law espoused by my brothers, it is clear that they announce an extraordinary, expansive, and incorrect reading of New York law solely because of their urge to "provid[e] a disincentive to insider trading." I agree with their objective but I question the means employed.

The court holds today that a person with no relationship whatsoever—fiduciary or otherwise—to a corporation, who trades its shares on the basis of material inside information becomes, *ipso facto,* a fiduciary of the corporation whose shares he traded and, accordingly, may be required in a *shareholders' derivative action*—not a Section 10(b) or 16(b) action—to pay his profits to the corporation. With all due respect to my brothers, the tortured reasoning to which they are compelled to resort in reaching this conclusion represents a distortion of the law of agency and the law of fiduciary responsibility in which I am unable to join. Accordingly, I dissent.

Stripped of excess verbiage, the complaints in the two consolidated stockholders' derivative actions before us make the following allegations. In January, 1970, Melvin Chasen, president of Lum's, learned that an earnings estimate of between $1.00 and $1.10 per share previously released to the

financial community was grossly inaccurate. A more realistic figure was $.76 per share. Chasen revealed this information on January 8, during a telephone conversation, to Benjamin Simon, an employee in Lehman Brothers Chicago office. Simon, in turn, disclosed the adverse news to Eugene Sit, portfolio manager of Investors Variable Payment Fund, Inc., who himself conveyed the information to James Jundt, portfolio manager of IDS New Dimensions Fund, Inc. Both Sit and Jundt are employees of Investors Diversified Services, Inc. (IDS), investment adviser to the two mutual funds. During the morning of Friday, January 9, prior to any public disclosure of the reduced earnings figure, the two mutual funds sold a total of 83,000 shares of Lum's stock on the New York Stock Exchange at a price of approximately $17.50 per share. Later that day, after the Exchange halted trading in Lum's shares, Lum's publicly announced the reduced earnings forecast. Trading did not resume until the following Monday, when the closing price fell to $14.00 per share.

It is important to note at the outset that the plaintiffs in these actions, shareholders of Lum's, do not claim to have suffered any damages themselves. Rather, these derivative suits are brought "on behalf of and for the benefit of Lum's." They seek to recover for Lum's treasury the windfall profit garnered by the IDS mutual funds, and assert that all defendants are jointly and severally liable for this amount. Thus, the proper method of analysis is not to focus on the unfairness of the mutual funds' profit at the expense of their purchasers—who have their own recourse for any wrongdoing—but on the strands of duty running to the corporation from the various individuals involved. The crux of the majority's holding is that the institutional defendants—Lehman Brothers, IDS, and the two mutual funds—and their employees—Simon, Sit, and

Jundt—are within the sweep of fiduciary principles announced in *Diamond* v. *Oreamuno,* 24 N.Y.2d 494, 301 N.Y.S.2d 78 (1969). But a careful examination of that case and the principles underlying it demonstrate that *Diamond* is wholly inapposite to this case.

In *Diamond,* the New York Court of Appeals dealt with a derivative action brought by a shareholder of Management Assistance, Inc. (MAI) against Oreamuno, chairman of the board of directors of the corporation, and Gonzalez, its president. The complaint charged that by virtue of their corporate positions, these officers knew that a supplier's price increase had caused MAI's earnings to decrease by more than 75% during a one month period. According to the allegations, the two officers sold over 50,000 MAI shares at a price of $28 per share prior to public disclosure of the adverse earnings figures, after which the price per share plummeted to $11. In reviewing the Appellate Division's refusal to order dismissal of the complaint against Oreamuno and Gonzalez, Chief Judge Fuld stated at the outset that "the question presented—one of first impression in this court—is whether *officers and directors* may be held accountable to their corporation for gains realized by them from transactions in the company's stock as a result of their use of material inside information," 24 N.Y.2d at 496, 301 N.Y.S.2d at 79 (emphasis added). A careful reading of the *Diamond* opinion reveals that Oreamuno's and Gonzalez's liability in a stockholders' derivative action was grounded solely in their having breached a fiduciary duty owed by them to MAI as corporate officials.

The inapplicability of these principles to any of the appellees[2] is readily apparent. The complaints here are

[2] As noted in the majority opinion, the only defendants remaining on appeal are Lehman Brothers, IDS, the two mutual funds, and Simon. The district court dismissed the actions against Chasen for lack of personal jurisdiction, a holding not challenged on appeal. Accordingly, this court need not comment on the nature and extent of Chasen's liability to Lum's because of his conduct.

barren of any allegation that the appellees—or Sit or Jundt —occupied any position, such as officer, director, employee, or agent, which would create fiduciary obligations to Lum's. *Compare Brophy* v. *Cities Service Co.*, 31 Del. Ch. 241, 70 A.2d 5 (1949); *Quinn* v. *Phipps*, 93 Fla. 805, 113 So. 419 (1927). Liability in *Diamond* was predicated entirely on such a relationship, and in its absence, the *Diamond* rationale for liability ceases to exist.

In an effort to bridge this fatal gap, the majority, without any basis in law or fact, reasons that the appellees were involved in a "joint" or "common enterprise" with Chasen, president of Lum's, "to misuse confidential corporate information for their own enrichment." By use of this interesting, but nevertheless fictional, theory, they seek to foist upon the appellees liability to Lum's for Chasen's improper behavior. But the facts alleged in the complaints are a far cry from the "conscious parallelism" cases, drawn from the antitrust field, cited as authority in the majority opinion; the facts simply do not comport with the concept of a joint enterprise, a term which implies the existence of a prior plan to carry out a mutually beneficial project. The complaints, read in the most favorable light to the plaintiffs, disclose nothing more than a seemingly unsolicited and haphazard revelation of certain information which was useful in making investment decisions. There are ample remedies under the federal securities laws to punish this conduct. But, I am unable to understand on what basis the majority transforms the appellees' spontaneous conduct into a nefarious, prearranged, and ongoing scheme so that "joint" or "common enterprise" principles can make them liable as fiduciaries of a corporation with which they have no relationship.

A primary authority upon which the majority relies, § 312 of the American Law Institute's Restatement of

Agency 2d, exposes the inappropriateness of holding the appellees liable to Lum's for their conduct. Section 312 provides that "A person who, without being privileged to do so, intentionally causes or assists an agent to violate a duty to his principal is subject to liability to the principal." Although Comment *c* to this section speaks generally of receipt of confidential information by a third person from a principal's agent, the central element of liability is the third party's active and intentional aiding in the agent's violation of a duty owed to his principal. In this case, Chasen's duty to Lum's was to not disclose confidential corporate information. Yet there is not a word in the complaint charging that the appellees actively solicited the disclosure or that they had concocted a prearranged scheme with Chasen.[3] We are dealing here with an isolated transaction.

In the absence of any coherent legal theory, I cannot join my brothers in approving the use of the shareholders' derivative action device merely because, as my brothers candidly admit, to do so possibly may have a deterrent effect on "insider trading." Although developments in federal securities law indicate an expanding scope of liability for tippee traders, *see In re* Investors Management Co., Securities and Exchange Commission Release No. 34-9267 (Jul. 29, 1971) (SEC sanctioning of institutional investors

3. It is of no small significance that in the *Diamond* litigation, the Appellate Division affirmed dismissal of the complaint against other MAI directors—fiduciaries to the corporation—who allegedly "approved, acquiesced in or ratified" Oreamuno's and Gonzalez's transactions. 29 A.D.2d 285, 287 N.Y.S.2d 300 (1968). Despite the majority's effort in a footnote to "distinguish" this disposition, I believe the Appellate Division's action is clearly dispositive of the point before us. If the New York courts would not impose liability upon a director—a fiduciary of the corporation—who took no affirmative steps to cause or assist in a breach of a fiduciary duty by the corporation's president, I fail to see by what logic it can be urged that New York courts would hold liable a non-fiduciary who did not cause or assist in the breach.

who sold a corporation's shares after the corporation's underwriter revealed adverse earnings results to them); *cf. SEC* v. *Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir. 1971), *cert. denied*, 404 U.S. 1005 (1972) (affirming district court order, in SEC injunctive suit, requiring a "tippor" to divest an amount equal to his tippees' profits), the impetus for developing this expanded federal law liability—whose exact nature and scope remain in a formative stage— is the need to maintain free and honest securities markets. This need appropriately is given great weight when we consider claims under the federal securities law. But it is inapposite in determining whether, *under state common law*, tippee trading is a breach of a fiduciary duty owed to the corporation whose shares are traded, and if so, whether such a breach is remediable through use of a shareholders' derivative action.

In these actions, where jurisdiction is grounded solely in diversity of citizenship, the parties and the majority agree that our duty is to apply the law of Florida. Yet because there are no pertinent Florida decisions, the majority focuses on a New York decision, *Diamond* v. *Oreamuno*, *supra*. Thus, liability is founded on the conclusion of two federal judges that the Florida Supreme Court, if the instant case was before it, would look to a New York decision and, in addition, would give an unprecedented expansive reading to that case.

Despite the manner in which the majority opinion convolutes the law and the facts in this case, a view that a tippee is cloaked with state law fiduciary obligations to the corporation whose shares he trades is an unknown and untenable legal concept. Neither *Diamond*—itself a significant alteration of the common law principles applicable to

an officer's or director's trading in his corporation's shares[4] —nor the law of agency support such a holding. Nothing in the majority opinion tells us why or on what grounds a New York court would hold a tippee trader liable to the corporation for his profits under common law fiduciary principles, and the court exceeds its authority by substituting its own view of what state law ought to be, for what the state law actually is.

Moreover, since the outcome of this case turns, ultimately, upon Florida law, I fail to comprehend why my brothers refuse to utilize Florida's certified question statute, Fla. Stat. Ann. §25.031.[5] This enlightened law provides for certification to the Florida Supreme Court by a federal appellate court of an unresolved question of Florida law which is determinative of a case before it and on which there are no clear, controlling Florida Supreme Court precedents. The statute states that the court, by

4. *See* Note, 1970 Wis. L. Rev. 576, 577. Although not dispositive, this fact augurs against assuming the state courts could make the broad holding so readily attributed to them by the majority.

5. The supreme court of this state may, by rule of court provide that, when it shall appear to the supreme court of the United States, to any circuit court of appeals of the United States, or to the court of appeals of the District of Columbia, that there are involved in any proceeding before it questions or propositions of the laws of this state, which are determinative of the said cause, and there are no clear controlling precedents in the decisions of the supreme court of this state, such federal appellate court may certify such questions or propositions of the laws of this state to the supreme court of this state for instructions concerning such questions or propositions of state law, which certificate the supreme court of this state, by written opinion, may answer.

This statutory authority has been implemented by Appellate Rule 4.61.

written opinion, then may answer the certified question. *See Aldrich* v. *Aldrich*, 375 U.S. 249 (1963); *Green* v. *American Tobacco Co.*, 304 F. 2d 170 (5th Cir. 1962). The uncertainty inherent in the majority's speculation over what the Florida courts would decide if faced with this novel question of tippee liability under state common law fiduciary principles in a stockholders' derivative action would be dispelled authoritatively and finally.

Accordingly, I respectfully dissent.

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the tenth day of May, one thousand nine hundred and seventy-three.

Present—Hon. STERRY R. WATERMAN
Hon. J. JOSEPH SMITH
Hon. IRVING R. KAUFMAN, Circuit Judges.

72-1373—72-1375

JACOB SCHEIN and MARVIN H. SCHEIN,
Plaintiffs-Appellants,

v.

MELVIN CHASEN; INVESTORS DIVERSIFIED SERVICES, INC.; LEHMAN BROTHERS; INVESTORS VARIABLE PAYMENT FUND, INC.; BENJAMIN SIMON; IDS; NEW DIMENSIONS FUND, INC.; EUGENE C. SIT; JAMES R. JUNDT and LUM'S, INC.,
Defendants-Appellees.

ANTONE F. GREGORIO, individually and as representative of all persons similarly situated as a class under Rule 23 FRCP,
Plaintiff-Appellant,

v.

LUM'S INC., MELVIN CHASEN, LEHMAN BROTHERS, BENJAMIN SIMON, INVESTORS DIVERSIFIED SERVICES, INC., EUGENE C. SIT and JAMES R. JUNDT,
Defendants-Appellees.

Appeal from the United States District Court for the Southern district of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is reversed and that the action be and it hereby is remanded to said District Court for further precedings consistent with the opinion of this court with costs to be taxed against the appellees.

A. Daniel Fusaro
Clerk

UNITED STATES COURT OF APPEALS

Second Circuit

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House in the City of New York, on the eighth day of June, one thousand nine hundred and seventy-three

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Jacob Schein and Marvin H. Schein,
Plaintiffs-Appellants,

v.

Melvin Chasen; Investors Diversified Services, Inc.; Lehman Brothers; Investors Variable Payment Fund, Inc.; Benjamin Simon; IDS; New Dimensions Fund, Inc.; Eugene S. Sit; James R. Jundt and Lum's, Inc.,
Defendants-Appellees.

Antone F. Gregorio, individually and as representative of all persons similarly situated as a class under Rule 23 FRCP,
Plaintiff-Appellant,

v.

Lum's Inc., Melvin Chasen; Lehman Brothers; Benjamin Simon; Investors Diversified Services, Inc.; Eugene S. Sit and James R. Jundt,
Defendants-Appellees.

A petition for rehearing in banc having been filed herein by counsel for the Defendant-Appellee Benjamin Simon and no active circuit judge having requested that a vote be taken on said suggestion

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

A. Daniel Fusaro
Clerk

UNITED STATES COURT OF APPEALS

Second Circuit

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the eighth day of June, one thousand nine hundred and seventy-three

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Jacob Schein and Marvin H. Schein,
Plaintiffs-Appellants,

v.

Melvin Chasen; Investors Diversified Services, Inc.; Lehman Brothers; Investors Variable Payment Fund, Inc.; Benjamin Simon; IDS; New Dimensions Fund, Inc.; Eugene S. Sit; James R. Jundt and Lum's, Inc.,
Defendants-Appellees.

Antone F. Gregorio, individually and as representative of all persons similarly situated as a class under Rule 23 FRCP,
Plaintiff-Appellant,

v.

Lum's Inc., Melvin Chasen, Lehman Brothers, Benjamin Simon, Investors Diversified Services, Inc., Eugene S. Sit and James R. Jundt,
Defendants-Appellees,

A petition for rehearing in banc having been filed herein by counsel for the appellee Lehman Brothers and no active circuit judge having requested that a vote be taken on said suggestion

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

A. Daniel Fusaro
Clerk

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

Docket Nos. 72-1373, 72-1375

At a stated term of the United States Court of Appeals in and for the Second Circuit held at the United States Court House, in the City of New York on the eighteenth day of June, one thousand nine hundred and seventy-three.

Present: Hon. IRVING R. KAUFMAN
Hon. S. R. WATERMAN
Hon. J. JOSEPH SMITH, Circuit Judges.

JACOB SCHEIN and MARVIN H. SCHEIN,
Plaintiffs-Appellants,

v.

MELVIN CHASEN; INVESTORS DIVERSIFIED SERVICES, INC.; LEHMAN BROTHERS; INVESTORS VARIABLE PAYMENT FUND, INC.; BENJAMIN SIMON; IDS; NEW DIMENSIONS FUND, INC.; EUGENE S. SIT; JAMES R. JUNDT and LUM'S, INC.,
Defendants-Appellees.

ANTONE F. GREGORIO, individually and as representative of all persons similarly situated as a class under Rule 23 FRCP,
Plaintiff-Appellant,

v.

LUM'S, INC.; MELVIN CHASEN, LEHMAN BROTHERS; BENJAMIN SIMON; INVESTORS DIVERSIFIED SERVICES, INC.; EUGENE S. SIT; and JAMES R. JUNDT,
Defendants-Appellees.

A petition for a rehearing having been filed herein for counsel for the appellees Investors Diversified Services, Inc., Investors Variable Payment Fund, Inc., and IDS New Dimensions Fund, Inc.,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

A. DANIEL FUSARO

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

Docket Nos. 72-1373, 72-1375

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the eighteenth day of June, one thousand nine hundred and seventy-three,

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JACOB SCHEIN and MARVIN H. SCHEIN,
Plaintiffs-Appellants,

v.

MELVIN CHASEN; INVESTORS DIVERSIFIED SERVICES, INC.; LEHMAN BROTHERS; INVESTORS VARIABLE PAYMENT FUND, INC.; BENJAMIN SIMON; IDS; NEW DIMENSIONS FUND, INC.; EUGENE S. SIT; JAMES R. JUNDT and LUM'S, INC.,
Defendants-Appellees.

ANTONE F. GREGORIO, individually and as representative of all persons similarly situated as a class under Rule 23 FRCP,
Plaintiff-Appellant,

v.

LUM'S, INC.; MELVIN CHASEN, LEHMAN BROTHERS; BENJAMIN SIMON; INVESTORS DIVERSIFIED SERVICES, INC.; EUGENE S. SIT and JAMES R. JUNDT,
Defendants-Appellees.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the appellees Investors Diversified Services, Inc., Investors Variable Payment Fund, Inc., and IDS New Dimensions Fund, Inc., and no active circuit judge having requested that a vote be taken on said suggestion.

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

A. DANIEL FUSARO
Clerk

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IN THE

Supreme Court of the United States

October Term, 1973

No. 73-440

BENJAMIN SIMON,

Petitioner, et al.,

v.

JACOB SCHEIN and MARVIN H. SCHEIN,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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September 6, 1973

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IN THE

Supreme Court of the United States

October Term, 1973

No. .....

BENJAMIN SIMON,

Petitioner, et al.,

v.

JACOB SCHEIN and MARVIN H. SCHEIN,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Petitioner, Benjamin Simon, respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in this proceeding on May 10, 1973.

Opinions Below

The opinion of the Court of Appeals, not yet reported, appears as Appendix A hereto. An opinion rendered by the District Court for the Southern District of New York on December 16, 1971, reported *sub nom. Gildenhorn* v. *Lum's, Inc.*, 335 F. Supp. 329 (S.D.N.Y. 1971), appears as Appendix B hereto.

Jurisdiction

The judgment of the Court of Appeals for the Second Circuit was entered in this case and the companion case of *Gregorio* v. *Lum's, Inc., et al.*, on May 10, 1973. A timely petition for rehearing *en banc* on behalf of defendant Simon was denied on June 8, 1973, and this petition for certiorari is filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

The original defendants in this action and in the companion *Gregorio* suit, in addition to the derivative corporate defendant Lum's, Inc., were Lum's chief executive officer, Melvin Chasen; the brokerage firm of Lehman Brothers* and (in the *Schein* action only) one of its registered representatives, the petitioner Benjamin Simon; Investors Diversified Services* ("IDS"), two IDS fund managers, Eugene Sit and James R. Jundt and (in the *Schein* action only) two IDS mutual funds, Investors Variable Payment Fund,* Inc. and IDS New Dimensions Fund, Inc.* Dismissal of both actions was ordered in the District Court as to the defendants Chasen, Sit and Jundt for lack of personal jurisdiction and no appeal was taken therefrom.

Questions Presented

1. Whether the Court of Appeals for the Second Circuit departed from its obligation to discover and apply Florida law in this diversity case by holding, without precedent in the law of Florida or any other state, that a corporation has a common law right of action against third persons not its fiduciaries for profits made by their "tip-

* Parties also filing petitions for certiorari.

pees" in trading the corporation's stock on the basis of material, non-public information?

2. Whether a federal court, confronted with a novel and important question of state law for which it can find no pertinent state authority, is not required to make use of the procedure, where the state has made one available, for certification of such questions to her highest court, rather than decide the case on the basis of its own view of what the "common law" should be?

Statutory Provisions Involved

Rules of Decision Act, 28 U.S.C. §1652:

State laws as rules of decision

"The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States in cases where they apply."

Florida Statutes Annotated, §25.031:

Supreme court authorized to receive and answer certificates as to state law from federal appellate courts.

"The supreme court of this state may, by rule of court, provide that, when it shall appear to the supreme court of the United States, to any circuit court of appeals of the United States, or to the court of appeals of the District of Columbia, that there are involved in any proceeding before it questions or propositions of the laws of this state, which are determinative of the said cause, and there are no clear controlling precedents in the decisions of the supreme court of this state, such

federal appellate court may certify such questions or propositions of the laws of this state to the supreme court of this state for instructions concerning such questions or propositions of state law, which certificate the supreme court of this state, by written opinion, may answer."

Statement of the Case

This shareholders derivative action was brought in the United States District Court for the Southern District of New York on behalf of Lum's, Inc., a Florida corporation engaged in the fast-food franchising business. The sole basis for federal jurisdiction is diversity of citizenship. It was conceded by all below that the governing law is that of the state of Florida, where the derivative defendant Lum's is incorporated.

The complaint alleged, in substance, that the defendant Melvin Chasen, as Lum's chief executive officer, learned that projections of the company's earnings were being revised substantially downward; that Chasen disclosed this information to the petitioner Benjamin Simon, a registered representative employed by Lehman Brothers, and that Simon conveyed the information to his clients, the portfolio managers Eugene Sit and James Jundt of IDS. On the next morning, the IDS funds managed by Sit and Jundt sold 63,000 shares of Lum's common stock at a price of approximately $17.50 per share. Later that day trading in Lum's was halted pending a company announcement with respect to the downward revision of its earnings projections. When trading resumed the next Monday, the opening price was down some three and one-half points

from the price the IDS funds had received the previous Friday.

The facts alleged in the instant complaint are the familiar stuff of actions brought under §10(b) of the Securities Exchange Act of 1934* and are indeed taken virtually verbatim from the complaints in pending actions arising from the same incident brought under Rule 10b-5** by the SEC and by purchasers of Lum's stock as a class.† The instant suit, however, alleges no violation of federal securities law. It asserts, instead, that Chasen of Lum's breached his fiduciary duty to that corporation by disclosing confidential information concerning its affairs to Simon, and that Simon, Lehman Brothers and the IDS defendants "aided and abetted" Chasen in his breach of duty by "[using] the aforesaid confidential information for their own personal profit." It was, however, established by uncontradicted affidavits below, and the District Court so found (App. 31a), that the IDS sale in question was not executed through Lehman Brothers and that neither Simon nor Lehman Brothers received any commission or other form of profit on the transaction.

Judge Tyler in the District Court for the Southern District of New York granted motions to dismiss pursuant to Rule 12 (b)(6) of the Federal Rules of Civil Procedure on behalf of Simon, Lehman Brothers, IDS and the IDS funds for failure to state a claim on which relief could be granted. Respondents' appeals from Judge Tyler's order of dismissal were argued in October, 1972 before a panel of

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* 15 U.S.C. §78j.

** 32 C.F.R. §240.10b-5 (1973).

† *SEC* v. *Lum's, Inc., et al.*, 70 Civ. 1734 (S.D.N.Y.); *Sanders* v. *Lum's, Inc., et al.*, 71 Civ. 5331 (S.D.N.Y.).

the Court of Appeals for the Second Circuit consisting of Judges Waterman, Smith and Kaufman. The Court of Appeals in an opinion by Judge Waterman, reversed the District Court and held that the complaints did state a claim on which relief could be granted. Judge Kaufman dissented.

Reasons for Granting the Writ

By its decision in this case, the Second Circuit Court of Appeals has enacted an important new piece of securities legislation. It is now the law in the Second Circuit that a person with no fiduciary or other relationship to a corporation, who trades its stock on the basis of material non-public information, becomes by that act a "fiduciary" accountable to the corporation for his "breach of duty." The right of the corporation under this new enactment is different than that afforded it by Congress to reach "insider short-swing profits" under Section 16(b) of the Securities Exchange Act of 1934; moreover, the corporation can recover, unlike a public investor suing under §10 (b), even though it sustains no damage by reason of the alleged wrongdoing. Nor is the benefit of this sweeping new legislation confined to Florida corporations, for the Court of Appeals, although ostensibly deciding a question of Florida law, in fact based its result on the "strong desirability of tightening the law of insider trading" (App. 11a), which concern it then assumed would impel a Florida court—and perforce the courts of any other of the other 49 states which have never imposed such liability—to punish for breach of fiduciary duty persons who owe no such duty under the common law.

This case should have been decided under Florida common law. It was not: Judge Kaufman pointed out in his

forceful dissent below that the "* * * view that a tippee is cloaked with the state law fiduciary obligations to the corporation in whose stock he trades is an unknown and untenable legal concept" (App. 22a-23a). Having established that Florida's courts—or indeed the courts of any other state—have never held non-profiting non-fiduciaries such as Simon and Lehman Brothers accountable to a corporation for tippee trading in its stock, the Court of Appeals should have concluded, as did the District Court, that the complaint in this action failed to state a claim upon which relief could be granted under applicable state law. Alternatively, the Court of Appeals might have resorted to the procedure, adopted by the Florida legislature "with rare foresight", *Clay* v. *Sun Insurance Office,* 363 U.S. 207, 212 (1960), which authorizes the Florida Supreme Court to answer unresolved questions of Florida law certified to it by a federal court. Instead, the majority below abandoned Florida law and, turning for "persuasive authority" (App. 6a) to the novel New York Court of Appeals decision in *Diamond* v. *Oreamuno,* 24 N.Y.2d 494, 301 N.Y.2d 78 (1969), gave that decision an unprecedented, expansive reading, based on federal securities law policy considerations, which has no foundation in the common law of Florida or any other state.

I

The Court of Appeals decision in this case is an abuse of federal jurisdiction.

The Rules of Decision Act and *Erie R. Co.* v. *Tompkins*, 304 U.S. 64 (1938), require that state law be applied in the federal courts to determine matters not governed by the Federal Constitution or by Acts of Congress. As Mr. Justice Brandeis said in *Erie*:

> "There is no federal general common law. Congress has no power to declare substantive rules of common law applicable in a state whether they be local in their nature or 'general', be they commercial law or part of the law of torts." 304 U.S. at 78.

This Court's supervisory responsibility for the proper functioning of the federal courts extends to insuring that the federal-state boundary drawn by *Erie* is properly observed. Its intervention is required where, as here, a federal court has departed from its obligation to discover and apply state law to make an important pronouncement of that "federal general common law" which *Erie* forbade.

In the instant case the Court of Appeals found, correctly, that no Florida court has faced "the precise issues" presented here (App. 7a). Instead of searching, however, as a Florida court would have done, for Florida decisions defining the nature of fiduciary obligation in analogous situations, the Second Circuit Court of Appeals turned to the unique New York Court of Appeals decision in *Diamond* v. *Oreamuno, supra,* which held for the first time

in any jurisdiction that a corporation may recover the profits of its officers and directors who abuse their office by trading on inside information even though the corporation sustains no damage by such trading. To justify its reliance on *Diamond*, the Court of Appeals cited two federal district court cases* which contain language to the effect that a federal court, presented with a question not passed upon by the courts of the state concerned, may reasonably assume that its courts would adopt the rule followed in a majority of jurisdictions. This Court has never given its approval to such a method of finding state law, but even if it were valid its proper application to this case would have resulted in dismissal of the complaint because *Diamond* v. *Oreamuno*, *supra*, being the law of only one state, is a "minority" and not a "majority" rule.

Having made one imaginative leap to assume that a Florida court would have decided this case under *Diamond*, the Court of Appeals took a second jump to find that a Florida court would extend *Diamond* to reach the third-party defendants in this case because "*Diamond*, the law of the jurisdiction in which the New York Stock Exchange is seated, has the prophylactic effect of providing a disincentive to insider trading" (App. 10a). As both Judge Kaufman and the able district judge below concluded, however, a reading of the *Diamond* case does not support its extension to reach alleged tippees such as petitioner Simon who were not officers or directors of the corporation involved.

Diamond v. *Oreamuno* was a derivative suit against the Chairman and President of a company alleging that they had learned, by virtue of their corporate positions, of a

* *Baxter* v. *Lancer Industries, Inc.*, 213 F. Supp. 92 (E.D.N.Y.), *appeal denied*, 324 F.2d 286 (2d Cir. 1963) and *Locke Mfg. Companies* v. *United States*, 237 F. Supp. 80 (D. Conn. 1964).

decrease in the company's earnings and had sold stock of the company before news of the decrease became public. At the outset of the Court of Appeals' opinion, Chief Judge Fuld stated that "the question presented—one of first impression in this Court—is whether *officers and directors* may be accountable to their corporation for gains realized by them from transactions in the company's stock as a result of their use of material inside information." 24 N.Y.2d at 496, 301 N.Y.S.2d at 79 (emphasis added). In holding that such liability might be imposed, the Court of Appeals reasoned that confidential information about a company is its property and cannot be appropriated by those who owe it a fiduciary duty, regardless of whether the corporation is damaged by the fiduciary's breach:

> "In our opinion, there can be no justification for permitting officers and directors, such as the defendants, to retain for themselves profits which, it is alleged, they derived solely from exploiting information granted by virtue of their inside position as corporate officials." 24 N.Y.2d at 498-99, 301 N.Y.S.2d at 81.

The holding in *Diamond* was based upon traditional equitable principles relating to duties owed by a fiduciary and on equity's distaste for allowing a fiduciary to profit from his office. Since the liability imposed by *Diamond* arises from the breach of a fiduciary duty, its holding has no application to a securities salesman such as the petitioner who owed no duty, fiduciary or otherwise, to Lum's. When no fiduciary duty exists, in short, it is manifest that there can be no cause of action for breach of such a duty.*

* The lone Florida decision cited in the text of the majority opinion below (App. 11a), *Quinn* v. *Phipps*, 93 Fla. 805, 113 So. 419 (1927), merely confirms this principle. The issue in *Quinn* was whether a real estate broker who negotiated a purchase of property for himself could be held liable to the client on whose behalf he had agreed to act, and the court's conclusion that a fiduciary relationship existed between the parties was, of course, the basis on which liability was imposed.

As this Court said in *West* v. *American Telephone & Telegraph Co.*, 311 U.S. 223 (1940), it is the duty of a federal court in a case governed by state law

> "* * * in every case to ascertain from all available data what the state law is and apply it rather than to prescribe a different rule, however superior it may appear from the viewpoint of 'general law' * * *." 311 U.S. at 237.

The Second Circuit Court of Appeals departed from its duty in this case by reasoning, not from common-law principles governing the duty owed by a fiduciary to his cestui que trust, but rather from its frequently expressed view of the "* * * desirability of tightening the law of insider trading" (App. 11a). Nor, indeed, is a right in the issuing corporation to recover the tippee's profits under state law consistent with the right of damaged investors to recover those profits in a suit under the federal securities laws. The potential for federal-state disharmony created by this decision is evident from the casual suggestion (App. 14a) of the majority below by way of a footnote reference to the remand opinion in *SEC* v. *Texas Gulf Sulphur*,* that the (federal?) court could require the corporation's recovery to be held for the benefit of injured stockholders. By what authority could a state court (or a federal court in a diversity case) so limit the corporation's common law "right"? The decision in this case is no less offensive to federal law than to the state law on which it should have been, but was not, founded.

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* 312 F. Supp. 77, 93 (S.D.N.Y. 1970), *aff'd in part, rev'd in part*, 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005, *reh. denied*, 404 U.S. 1064 (1971).

II

The Court of Appeals should have turned to Florida's Supreme Court for an authoritative answer to the question presented by this case.

The Second Circuit Court of Appeals decision in this case exemplifies the difficulties which federal courts sometimes encounter, and the temptations to which they may succumb, when confronted with an important question of state law for which there is no apparent state precedent. The majority below professed itself unable to decide this case by reference to Florida authority—but the very absence of such authority renders purely speculative the majority's conclusion that a Florida court would have adopted its reasoning. The Second Circuit's result here cannot be defended, as was its decision in *Propper* v. *Clark*, 337 U.S. 472, 486-87 (1949), as the "reasonable conclusion" of a federal court skilled in the law of the particular state. The Second Circuit, whatever its expertise in interpreting New York law, can lay claim to none in interpreting the law of Florida, and there is no reason to suppose that the tortuous process by which it reached its conclusion in this case represents the law of Florida. Here, moreover, by contrast with *Propper*, the federal judges who heard this case were evenly divided as to whether the complaint stated a claim for relief under New York law as enunciated in *Diamond*, Judge Tyler in the District Court and Judge Kaufman in the Court of Appeals being strongly of the view that it did not.

Both the necessity for speculation and the tendency exhibited here of federal judges to write their own laws

when state law as they perceive it is a blank, are unhealthy to sound federal-state relations. Both should be minimized as far as possible. Here they could have been eliminated altogether, by resort to Florida's well-established procedure, adopted following this Court's decision in *Meredith* v. *Winter Haven,* 320 U.S. (1943), for the certification to its Supreme Court of unresolved questions of Florida law arising in the federal courts.*

Use of the Florida certification procedure was required by this Court in *Clay* v. *Sun Insurance Office,* 363 U.S. 207 (1960), where a lower federal court, apparently deeming the state law issue more difficult than the constitutional one, held a Florida statute unconstitutional without deciding whether the statute would apply to nullify a provision of the contract in question. This Court, seeking to avoid the unnecessary decision of the constitutional issue, remanded the case for a determination of whether the Florida statute applied as a matter of state law:

> "The Florida Legislature, with rare foresight, has dealt with the problem of authoritatively determining unresolved state law involved in federal litigation by a statute which permits a federal court to certify such a doubtful question of state law to the Supreme Court of Florida for its decision. Fla. Stat. Ann., 1957, §25.031. Even without such a facilitating statute we have frequently deemed it appropriate, where a federal constitutional question might be mooted thereby, to secure an authoritative state court's determination of an unresolved question of its local law." 363 U.S. at 212.

* The current version of this statute, originally adopted in 1945, is reproduced *supra* at page 3.

Use of Florida's certification procedure was subsequently directed by this Court in *Dresner* v. *City of Tallahassee*, 375 U.S. 136 (1963) and in *Aldrich* v. *Aldrich*, 375 U.S. 249 (1963). The Fifth Circuit has also uniformly certified "doubtful questions" of Florida law to the Florida Supreme Court.* In *Martinez* v. *Rodriquez*, 410 F.2d 729 (5th Cir. 1969), the court commended the dispatch with which Florida's Supreme Court responded to such inquiries and stated:

> "We would be remiss if we did not once again seize the opportunity to extol the virtues of the Florida certification procedure. For example, while this Court following the footsteps of the stalwarts below might have reached the same conclusion as that of the Florida Court with respect to the issue in this case, our decision would have had no assurance of predictable correctness. No matter how many Federal Judges, trial, appellate, three-Judge panel, or the full panoply of the court en banc, any decision would have been an *Erie*-guess. Now the guesswork has been eliminated, and we are quickly presented with a definitive explication of Florida law." 410 F.2d at 730.

Florida's enactment of the certification procedure represents the considered policy and preference of her Legislature to avoid precisely what happened in this case—the pronouncement by a distant federal court of an unprecedented expansion of a unique New York decision as

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* *See, e.g., Gordon* v. *John Deere Co.*, 451 F.2d 234 (5th Cir. 1971); *Allen* v. *Estate of Carman*, 446 F.2d 1276 (5th Cir. 1971); *A. R. Moyer, Inc.* v. *Graham*, 443 F.2d 434 (5th Cir. 1971); *Boyd* v. *Bowman*, 443 F.2d 848 (5th Cir. 1971); *Trail Builders Supply Co.* v. *Reagan*, 409 F.2d 1059 (5th Cir. 1969); *Gaston* v. *Pittman*, 405 F.2d 869 (5th Cir. 1969); *Life Insurance Co. of Va.* v. *Schifflet*, 370 F.2d 555 (5th Cir. 1967); and *Hopkins* v. *Lockheed Aircraft Corp.*, 358 F.2d 347 (5th Cir. 1966).

"Florida law". As Florida dislikes such speculation and has provided a statutory means for avoiding it, her preference should be respected, not only in the Fifth Circuit but throughout the federal court system.

This Court required resort to Florida's certification procedure in *Clay, supra*, for the purpose of avoidng an unnecessary constitutional decision rather than for the purpose proposed here, which is to avoid unnecessary guesswork by the federal courts, as well as impermissible crossings of the *Erie* line, in passing upon important questions of state law. Although this Court has not passed upon use of the certification procedure for this latter purpose, it has nonetheless demonstrated its willingness to require a federal court to stay its hand in the interests of comity and harmonious federal-state relations even where no federal constitutional issue was presented. *Kaiser Steel Corp.* v. *W. S. Ranch Co.*, 391 U.S. 593 (1968), was a diversity suit involving the interpretation of a New Mexico statute concerning water rights and its validity under the state constitution. A declaratory judgment action to determine the critical state issues was pending in the state courts. This Court, holding that the federal appellate court had erred in refusing to stay the federal suit pending the state court's determination, observed that the state law issues involved were of vital concern, were truly novel and in all likelihood would soon be resolved by the state court.

A stay of federal court proceedings pending a forthcoming state determination such as was ordered in *Kaiser* is similar to use of a state's certification procedure in the important respect that, in both instances, the desirable

objective of obtaining an authoritative resolution of the state law question is achieved without the sacrifice of the federal court's jurisdiction. In its 1943 decision in *Meredith* v. *Winter Haven, supra,* this Court held that, except in special circumstances where abstention might be necessary to avoid a constitutional issue, a federal court was required to decide state law questions presented to it, no matter how obscure or difficult they might be, in order not to defeat federal diversity jurisdiction. In *Meredith* and many simliar cases, the result of abstention would have been the inability of the federal court to entertain the action and, consequently, its dismissal. To require federal courts to make use, in appropriate cases, of the certification procedure of Florida or other states would not offend the rationale of *Meredith* because certification would not divest the federal court of its jurisdiction or otherwise deprive it of its authority to hear and decide the case.

It is important that novel questions of state law arising in the federal courts be decided under the law of the state concerned and not, as here, on the basis of unfounded speculation. The very limitations which this Court has imposed on its review of federal court determinations of state law issues make it all the more important that the federal court's decision, insofar as possible, represent an authoritative statement of state law. Difficulties arise, of course, in those infrequent instances where applicable state law furnishes the federal court with no basis whatsoever for arriving at a reasonable "forecast" of how the state's highest court would decide the question. It is submitted, however, on behalf of petitioner Simon, that where a state such as Florida has made available to the federal courts

a means for obtaining an authoritative answer to such a question, the federal court should be required to take advantage of that procedure rather than setting sail, as the Second Circuit did in this case, under its own stars.

Conclusion

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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WHITE & CASE
Of Counsel

September 6, 1973

APPENDICES

Appendix A

Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 81 and 82—September Term, 1972

(Argued October 17, 1972 Decided May 10, 1973)

Docket Nos. 72-1373, 72-1375

JACOB SCHEIN and MARVIN H. SCHEIN,
Plaintiffs-Appellants,

v.

MELVIN CHASEN, INVESTORS DIVERSIFIED SERVICES, INC., LEHMAN BROTHERS, INVESTORS VARIABLE PAYMENT FUND, INC., BENJAMIN SIMON, IDS NEW DIMENSIONS FUND, INC., EUGENE S. SIT, JAMES R. JUNDT, and LUM'S, INC.,
Defendants-Appellees.

ANTONE F. GREGORIO, individually and as representative of all persons similarly situated as a class under Rule 23, F.R.C.P.,
Plaintiff-Appellant,

v.

LUM'S, INC., MELVIN CHASEN, LEHMAN BROTHERS, BENJAMIN SIMON, INVESTORS DIVERSIFIED SERVICES, INC., EUGENE S. SIT, and JAMES R. JUNDT,
Defendants-Appellees.

Before:

WATERMAN, SMITH and KAUFMAN, *Circuit Judges.*

Invoking the diversity jurisdiction of the court, plaintiffs in three cases consolidated below sued derivatively

in United States District Court for the Southern District of New York, Tyler, *J.*, alleging that defendants were jointly and severally liable under state corporation law for the profits realized by the defendants Mutual Funds through their trading on the New York Stock Exchange in derivative defendant's stock on the basis of non-public material inside information. An order granting summary judgment was granted to defendants and in two of the consolidated actions the parties have argued appeals.

Reversed and remanded for further proceedings consistent with this opinion.

WATERMAN, *Circuit Judge*:

Plaintiffs-appellants are stockholders in Lum's, Inc., a Florida corporation primarily engaged in restaurant franchising. Invoking the diversity jurisdiction of the court, they sued derivatively in the Southern District of New York alleging that the defendants were jointly and severally liable to Lum's for actionable wrongs which the defendants had committed against Lum's. The individual defendants were Melvin Chasen, a resident of Florida, president of Lum's, Benjamin Simon, a stockbroker employed in Chicago, Ill. by defendant Lehman Brothers, Eugene S. Sit, portfolio manager of defendant IDS New Dimensions Fund, Inc., a Mutual Fund, and James R. Jundt, manager of defendant Investors Variable Payment Fund, Inc., a Mutual Fund. Each of the four individual defendants moved for dismissal on the ground that they had not been validly served under the New York Long Arm

Statutes (CPLR §§313, 302(a)) and that the court below had no personal jurisdiction of them. Sit's and Jundt's motions were granted prior to the filing of the order appealed from, Chasen's was granted concurrently therewith, and Simon's has apparently not been acted upon.[1] The defendants Lehman Brothers, a partnership engaged in stock brokerage and investment counseling, the three corporations, engaged in managing investment portfolios and in buying and selling the corporate securities of publicly held corporations, Chasen, and Simon, all moved for dismissal on the ground that the complaints failed to state a cause of action under Florida law. Plaintiffs claimed that New York law should govern the rights and liabilities of the parties, and that even if Florida law were the applicable law they should still prevail. Holding that Florida law was the proper state law to apply, Judge Harold R. Tyler, Jr., by written order, *sub nom Gildenhorn* v. *Lum's, Inc.*, opinion reported at 335 F.Supp. 329 (SDNY 1971), granted the motion to dismiss for failure to state a claim upon which relief could be granted.

On this appeal plaintiffs claim only that Judge Tyler erred in dismissing the complains for failure to state a

1. Plaintiffs-appellants have not appealed the order dismissing the actions against Chasen, Sit and Jundt. Simon filed a similar dismissal motion but the trial court did not decide it. Simon was dismissed as a defendant by the court's order dismissing the complaints against all defendants for failure to state a cause of action under 12(b)(6) of the Fed. R. Civ. P. Simon contends on this appeal that irrespective of our action on the lower court's dismissal of the complaints under 12(b)(6), we should dismiss the action against him because he has not been validly served. However, inasmuch as the trial court has not reached this question, we decline to address it on this appeal, and leave its resolution to the trial court upon remand.

cause of action.[2] They do not appeal Judge Tyler's order dismissing Chasen as a defendant or his finding that the substantive law of Florida governs the action.[3] Inasmuch as the court is passing only upon the sufficiency of the complaints, we necessarily accept the allegations of the complaints as true. For reasons which follow, we hold that the complaints do state a cause of action and we reverse the judgment below and remand to the district court for further proceedings there in the light of this holding.

The facts alleged in this case fall within the perimeter of the much-discussed problem of unfair trading in corporate securities. In November of 1969 Chasen, who was president and chief operating officer of Lum's, addressed a seminar of about sixty members of the securities industry with reference to Lum's earnings prospects for its fiscal year ending July 31, 1970. He informed them that Lum's earnings would be approximately $1.00 to $1.10 per share. On January 5, 1970 he learned that this estimate was too optimistic and that, in fact, Lum's earnings would be only approximately $.76 per share. Three days later, prior to announcing the information to the public, Chasen telephoned Simon in Chicago and told Simon that Lum's would not have as profitable a year as had been expected. He specified to Simon that earnings would be approximately $.76 per share rather than the $1.00 per share which he had earlier announced. Simon knew the information was

2. In one of the original actions consolidated below, Gildenhorn v. Lum's, Inc., 335 F.Supp. 329 (SDNY 1971) a notice of appeal was filed by plaintiff but the parties have not progressed the appeal.

3. The parties now agree that the substantive law of the State of Florida governs the action for reasons which are stated in Judge Tyler's opinion reported at 335 F.Supp. 329 (SDNY 1971).

confidential corporate property which Chasen had not given out publicly. Simon immediately telephoned this information to Sit, an employee of defendant Investors Diversified Services, Inc. (IDS),[4] and Sit immediately telephoned it to Jundt, another employee of IDS. Sit and Jundt managed the stock portfolios of defendant mutual funds Investors Variable Payment Fund, Inc. (Investors) and IDS New Dimension Fund, Inc. (Dimensions). Upon receiving the information Sit and Jundt directed the Funds to sell their entire stock holdings in Lum's and, on the morning of January 9, 1970, prior to any public announcement, Investors sold 43,000 shares of Lum's and Dimensions sold 40,000 shares. The sales were executed on the New York Stock Exchange at about 10:30 A.M. at a price of approximately $17.50 per share. At 1:30 P.M. on the same day, the New York Stock Exchange halted further trading in Lum's stock pending a company announcement. At 2:45 P.M. Lum's issued a release which appeared on the Dow Jones News Wire Service and announced that the corporation's projected earnings would be lower than had been anticipated. When trading in Lum's was resumed on Monday, January 12, 1970, volume was heavy and the stock closed at a price of $14.00 per share—$3.50 per share lower than the Funds had realized from the sales of their shares on the previous Friday.

The present defendants in this case are Lehman Brothers, Simon, and the two Mutual Funds. Chasen,

4. Defendant IDS is a Minnesota corporation licensed to do business in the State of New York. IDS is the distributor and investment advisor for a number of large mutual funds including defendants Investors and Dimensions. Sit and Jundt are employed by IDS to manage the stock portfolios of Investors and Dimensions.

Sit, and Jundt have been dismissed as defendants in that they had not been validly served under the New York State Long Arm Statute. Plaintiffs-appellants' theory of recovery is that the participants in this chain of wrongdoing are jointly and severally liable to the corporation under Florida law for misusing corporate information to their own advantage in violation of the duty they owed to Lum's, and that they must account to Lum's for the profits realized by the Mutual Funds. They do not allege in these complaints that defendants have violated any of the federal securities laws,[5] and they concede that the substantive law of Florida governs the rights and liabilities of the parties. They urge, however, that inasmuch as there are no Florida cases directly in point, the Florida court, if it were deciding the case, would look to other jurisdictions and would take a particular and special interest in the decision of *Diamond* v. *Oreamuno,* 29 A.D.2d 285, 287 N.Y.S.2d 300 (1st Dep't 1968), *aff'd* 24 N.Y.2d 494, 301 N.Y.S.2d 78 (1969), a case which plaintiffs contend supports the position they urge on this appeal.

The first question which our court must consider is whether we may look to the New York decision of *Diamond, supra,* as persuasive authority. Ideally, the federal court sitting in a diversity action applies the applicable state law as it has been enunciated by the highest court in the state. *Erie R. Co.* v. *Tompkins,* 304 U.S. 64 (1938); *Haus-*

5. Lum's could apparently not prevail as a plaintiff in a Rule 10b-5 action in that it has not traded in its securities on its own account. See Birnbaum v. Newport Steel Corporation, 193 F.2d 461 (2 Cir. 1952), cert. denied, 343 U.S. 956 (1952). Although there are federal securities law cases pending against defendants in district court, this fact is irrelevant upon this appeal.

man v. *Buckley,* 299 F.2d 696 (2 Cir. 1962), *cert. denied,* 369 U.S. 885 (1962). However, in the absence of a clearly enunciated state rule, the federal court may turn to the law of other jurisdictions for assistance in determining how the state court would most likely decide the case if the state court were presented with the questions being litigated in the federal court. *Baxter* v. *Lancer Industries, Inc.,* 213 F.Supp. 92 (EDNY 1963), *app. denied,* 324 F.2d 286 (2 Cir. 1963); *Locke Manufacturing Companies* v. *United States,* 237 F.Supp. 80 (D. Conn. 1964). Our foray into the state law of Florida satisfies us that the Florida court has never faced the precise issues which are present in this action. Accordingly, it is both proper and practical for this court to turn for guidance to the body of law of other jurisdictions and particularly to that of New York where the resolution of the issues in the *Diamond* case, decided by the New York Court of Appeals, bears on the issues in the base before us. In doing so, our objective is to interpret *Diamond* as the Florida court would probably interpret it and to apply *Diamond,* as so interpreted, to the facts presented here.

Diamond v. *Oreamuno, supra,* was a stockholder's derivative action in which a shareholder of Management Assistance, Inc. (MAI) charged that two of the defendants —Oreamuno, chairman of the board of directors, and Gonzales, its president and a member of the board, had used inside information acquired by them solely by virtue of their positions with MAI in order to reap large personal profits from the sale of MAI shares, and that these profits rightfully belonged to the corporation. Chief Judge Stan-

ley Fuld, writing for a unanimous court, held that the two directors must account to the corporation for their profits for they had breached their duty to the corporation by using a corporate asset for their own personal advantage.

In this case we are asked to decide whether the *Diamond* holding should extend to reach third parties who, though not officers or directors of the injured corporation, are involved with directors in a common enterprise to misuse confidential corporate information for their own enrichment. Although there is no allegation in the complaints that a prior explicit agreement existed between Chasen and the defendants, it is obvious that the sequence of events detailed in the pleadings, if proved, will substantiate the existence of a common enterprise pursuant to which Chasen was to pass material information to Simon, Simon was to pass it to the Mutual Funds, and the Funds were to capitalize on it by selling Lum's stock prior to the time the material information was announced to and was available to the public. Cf. *American Tobacco Co.* v. *United States*, 328 U.S. 781 (1946); *Interstate Circuit, Inc.* v. *United States*, 306 U.S. 208 (1939); *Norfolk Monument Company* v. *Woodlawn Memorial Gardens, Inc.*, 394 U.S. 700 (1969). Although defendants do not deny that they have been involved in a joint enterprise with Chasen to misuse corporate property, they argue that the doctrine of *Diamond* is not applicable here and that they cannot be held liable to Lum's because they are not Lum's fiduciaries and have not breached any duty which they owed to Lum's by cashing in on confidential information for their own advantage. Defendants Simon and Lehman

Brothers make the further argument that it would be "unfair" to hold them responsible for the profits made by the Mutual Funds in that they (Simon and Lehman Brothers) did not profit personally inasmuch as neither of them traded in Lum's stock.

As a court of equity viewing the case as the Florida court would probably view it, we cannot agree that the "stretch" of *Diamond* does not reach the defendants in this case. We find nothing in the language of *Diamond* to suggest that co-venturers of the director who breaches his duty should not be subject to the same liabilities as those of the director himself for the misuse of corporate information.[6] Indeed, the general rule has always been that "one who knowingly participates in or joins in an enterprise whereby a violation of a fiduciary obligation is effected is liable jointly and severally with the recreant fiduciary." *Oil & Gas Ventures—First 1958 Fund Ltd.* v. *Kung*, 250 F.Supp. 744 (1966); see, *e.g.*, *Jackson* v. *Smith*, 254 U.S. 586, 589 (1921); *Sexton* v. *Sword S.S. Line, Inc.*, 118 F.2d 708, 711 (2 Cir. 1941); *Bankers Life and Casualty Co.* v. *Kirtley*, 338 F.2d 1006, 1013 (8 Cir. 1964). If the *Diamond* court had intended to lay down an exception to this well-known general rule it could have done so in its

6. We believe Judge Tyler erred in attaching dispositive significance to the fact that in Diamond, supra, the complaint was dismissed against certain directors who had only "acquiesced" in the wrong. The defendants-appellees here differ from the dismissed Diamond defendants in that the defendants-appellees were actively engaged in furthering the transaction that resulted in the "dumping" of the Lum's stock, rather than just "acquiescing" in it. Furthermore, and even more importantly, Diamond was not a "joint venture" case, and there is no discussion in the Diamond opinion as to why the complaint was dismissed against the "acquiescing" directors.

opinion. Moreover, in the light of the corporate interest which the *Diamond* rule is designed to protect, it is immaterial to the preservation of that interest whether the director trades on his own account in the corporation's stock or whether he passes on the information to outsiders who then trade in the corporation's stock. In either event, so long as the director is involved, the prestige and good will of the corporation may be tarnished by the public revelation that the director has been involved in unethical conduct. *Diamond, supra* at 499; accord, *S.E.C.* v. *Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2 Cir. 1971), *cert. denied*, 404 U.S. 1005, *reh. denied*, 404 U.S. 1064 (1972). Accordingly, it would be self-defeating to limit the reach of *Diamond* to directors and officers of the injured corporation who have so acted while permitting third-party co-venturers of theirs to escape liability to the corporation.

Diamond, the law of the jurisdiction in which the New York Stock Exchange is seated, has the prophylactic effect of providing a disincentive to insider trading. It is clear that this cleansing effect ought to reach third parties who, through a breach of a fiduciary relationship, become traders advantageously possessed of confidential insider knowledge. To immunize such third parties from liability to the damaged corporation would encourage insider "leaks" to outside friends and would defeat *Diamond's* purpose and effect. And, quite properly, damage for fiduciary breaches are recoverable by recourse to state law. Indeed, though the congressional policy is similar, in some cases where federal private and governmental Rule 10b-5 actions are impractical, "immunized outsiders"

might escape liability altogether except for the availability of this kind of action bottomed upon the well-recognized liability of a fiduciary to those whose trust in the fiduciary has been tragically misplaced. In view of the strong desirability of tightening the law of insider trading, we would be remiss indeed if we interpreted *Diamond* as narrowly as defendants would have us interpret it. Moreover, sitting as a court of equity, we have here an obligation to determine where the equities lie among all the litigants, *Diamond, supra* at 498, and, as between the defendants and Lum's, there can be no doubt that it would be inequitable to permit the defendants to keep the rewards of fraud.[7]

Our view that all the participants in the common enterprise must assume the same risks of liability to the corporation as the offending director is supported by Florida case law dealing with the duty of a fiduciary to his cestui. The Florida courts have held that the duty of a fiduciary not to misuse the property of his cestui extends not only to the "technical fiduciary" but also to others who are placed in a position of trust. *Quinn* v. *Phipps*, 93 Fla. 805, 113 So. 419 (1927). The confidential relationship of a fiduciary as that relationship is spelled out in Florida

7. This principle has been applied in analogous cases involving violations of the federal securities laws. In more than one instance, the corporation whose stock has been illegally traded has been permitted to recover conditionally in a Rule 10b-5 action because it is more equitable for it to recoup the rewards of the fraud than for the insider who profits by misusing corporate information to keep them. See Securities and Exchange Commission v. Texas Gulf Sulphur, 446 F.2d at 1308; S.E.C. v. Golconda Mining Company, 327 F.Supp. 257 (SDNY 1971).

law extends not only to "technical fiduciaries" but also to others who become "fiduciaries" through the acquisition of confidential information which is "owned" by someone else. See *Quinn* v. *Phipps*, supra at 420-421. When the defendants received their "tip" from Chasen, they were automatically clothed with a duty to Lum's not to use the information for their own selfish advantages. Compare *Brophy* v. *Cities Service Co.*, 31 Del. Ch. 241, 70 A.2d 5 (1949); *Ohio Oil Co.* v. *Sharp*, 135 F.2d 303 (10 Cir. 1943). This is firmly grounded in law and the rule is set forth in the American Law Institute's Restatement of Agency 2d §312 (1958): "A person who, without being privileged to do so, intentionally causes or assists an agent to violate a duty to his principal is subject to liability to the principal." And see Comment c to §312:

> A person who, with notice that an agent is thereby violating his duty to his principal, receives confidential information from the agent, may be enjoined from disclosing it and required to hold profits received by its use as a constructive trustee. * * *

Therefore, if plaintiffs can prove their allegations, it would seem that liability of the Mutual Funds to Lum's must necessarily follow. Be that as it may be however, the defendants Lehman Brothers and Simon contend that it would be inequitable to apply the rule to them because they did not personally profit by trading in Lum's stock and they hold no profits as constructive trustees of that corporation. Nevertheless, Lehman Brothers and Simon obviously misused inside information as much as Diversified

and Investors misused it, and therefore we fail to see how equity would be furthered by imposing liability only on the Funds and not on the other participants who supplied the Funds with the inside information. It is well established that the liabilities of persons engaged in a joint enterprise to commit a wrong are both joint and several liabilities and each participant is liable to account for the profits of the other participants. *Marcus* v. *Otis,* 168 F.2d 649 (2 Cir. 1948), *modified,* 169 F.2d 148 (2 Cir. 1948); *Solomon* v. *United States,* 276 F.2d 669 (6 Cir. 1960), *cert. denied,* 364 U.S. 890 (1960), *reh. denied,* 364 U.S. 939 (1961). Accordingly, we hold that it would be proper to hold Lehman Brothers and Simon just as accountable for the profits made by their tippees Diversified and Investors as the tippees themselves.[8]

Defendants also contend that the complaints are presently insufficient because they fail to allege with sufficient particularity the damages Lum's is claimed to have suffered. This contention is without merit. Although the Gregorio complaint fails to allege any damages to Lum's, the Schein complaint contains a general allegation of dam-

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8. In passing we note decisions dealing with violations of the federal securities laws which involve the imposition of liabilty on defendants who have occupied statuses similar to the statuses occupied by defendants in this case. Thus, in Securities and Exchange Commission v. Texas Gulf Sulphur, 446 F.2d at 1308, the same argument raised by Simon and by Lehman Brothers was raised by defendant Darke. This court held that Darke was liable as a tippor for the profits realized by his tippees. Furthermore, "tippee liability," which is analogous to the liability being imposed upon Diversified and Investors, has been established in federal cases involving violations of the securities laws. See Ross v. Licht, 263 F.Supp. 395 (SDNY 1967); In the Matter of Cady, Robers & Co., 40 S.E.C. 907 (1961).

ages, and we find nothing in Florida law to require anything more than a general ad damnum allegation.[9]

Defendants also urge that inasmuch as there are private Rule 10b-5 class actions for damages, *e.g., Sanders* v. *Lum's, Inc., et al,* 70 Civ. 5331 (SDNY) and an administrative suit brought by the Securities and Exchange Commission, *SEC* v. *Lum's et al,* 70 Civ. 5280 (SDNY), pending in federal district court, defendants might be subjected to multiple liability if they are forced to remit to Lum's the profits the Mutual Funds made on their January 9 sales. Since appellees are fully aware of these federal court actions they are well able to protect themselves from multiple liability.[10]

Preventing those who are privy to confidential inside information from using it to their own advantage has found expression in numerous cases in the federal courts dealing with violations of the federal securities laws. See *Securities and Exchange Commission* v. *Texas Gulf Sulphur,* 401 F.2d 833 (2 Cir. 1968), *cert. denied sub nom.*

9. We find it unnecessary to decide whether the defendants could prevail if *neither* complaint alleged damages to Lum's. We point out, however, that Florida law is not clear on the question and Diamond holds specifically that an allegation of damages is not a prerequisite to a recovery. Diamond v. Oreamuno, supra at 499. The case cited by defendants for the proposition that damages must be alleged (Palma v. Zerbey, 189 So.2d 510 (Fla.App. 1966), cert. denied, 200 So.2d 814 (Fla. 1967) is a one paragraph per curiam opinion of a lower Florida court, the Florida District Court of Appeals which, inasmuch as it fails to provide a discussion of the issues, we find to be totally unpersuasive.

10. See, for example, the method employed in Securities and Exchange Commission v. Texas Gulf Sulphur Co., 312 F.Supp. 77, 93 (SDNY 1970), *aff'd in part, rev'd in part,* 446 F.2d 1301 (2 Cir. 1971), cert. denied, 404 U.S. 1005 (1971), reh. denied, 404 U.S. 1064 (1971).

Coats v. *SEC*, 394 U.S. 976 (1969); *List* v. *Fashion Park, Inc.*, 340 F.2d 457 (2 Cir. 1965), *cert. denied*, 382 U.S. 811 (1965); *Wohl* v. *Blair & Co.*, 50 F.R.D. 89 (SDNY 1970); *Ross* v. *Licht*, 263 F.Supp. 395 (SDNY 1967); *Speed* v. *Transamerica Corp.*, 99 F.Supp. 808, 828-829 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3 Cir. 1956).

Accordingly, as to those persons found to be within the jurisdiction of the court, we reverse the order appealed from and remand the case for such further proceedings below as may be consistent with the contents of this opinion.

Appendix A—Dissenting Opinion of the Court of Appeals

KAUFMAN, *Circuit Judge* (dissenting):

In my view, it is no longer debatable that trading on inside information merits universal condemnation.[1] The undesirable nature of "insider trading" is reflected in the prophylactic provisions of Section 16(b) of the Securities Exchange Act of 1934 and the more general antifraud principles of Section 10b of that Act. I fully agree with Judges Waterman and Smith that one with access to material inside information concerning a corporation's affairs who knowingly purchases or sells that corporation's shares before this information has become publicly available takes unfair advantage of unknowledgeable parties to the transaction. Indeed, the factual claims contained in the complaints before us have led to two federal actions—an SEC injunctive action and a private class action under rule 10b-5—now pending in the District Court for the Southern District of New York. But the adage that hard facts make bad law is about to come true here, despite Judge, later Justice, Cardozo's warning that judges are not free agents roaming at will to create law to fit the facts. *See* The Nature of the Judicial Process 141 (1921). In the absence of any viable precedent upon which to base the totally new concept of law espoused by my brothers, it is clear that they announce an extraordinary, expansive, and incorrect reading of New York law solely because of their urge to "provid[e] a disincentive to insider trading." I agree with their objective but I question the means employed.

1. But for a contrary view, *see* H. Manne, Insider Trading and the Stock Market (1966).

The court holds today that a person with no relationship whatsoever—fiduciary or otherwise—to a corporation, who trades its shares on the basis of material inside information becomes, *ipso facto,* a fiduciary of the corporation whose shares he traded and, accordingly, may be required in a *shareholders' derivative action*—not a Section 10(b) or 16(b) action—to pay his profits to the corporation. With all due respect to my brothers, the tortured reasoning to which they are compelled to resort in reaching this conclusion represents a distortion of the law of agency and the law of fiduciary responsibility in which I am unable to join. Accordingly, I dissent.

Stripped of excess verbiage, the complaints in the two consolidated stockholders' derivative actions before us make the following allegations. In January, 1970, Melvin Chasen, president of Lum's, learned that an earnings estimate of between $1.00 and $1.10 per share previously released to the financial community was grossly inaccurate. A more realistic figure was $.76 per share. Chasen revealed this information on January 8, during a telephone conversation, to Benjamin Simon, an employee in Lehman Brothers Chicago office. Simon, in turn, disclosed the adverse news to Eugene Sit, portfolio manager of Investors Variable Payment Fund, Inc., who himself conveyed the information to James Jundt, portfolio manager of IDS New Dimension Fund, Inc. Both Sit and Jundt are employees of Investors Diversified Services, Inc. (IDS), investment adviser to the two mutual funds. During the morning of Friday, January 9, prior to any public disclosure of the reduced earnings figure, the two mutual funds sold a total of 33,000 shares of Lum's stock on the

New York Stoch Exchange at a price of approximately $17.50 per share. Later that day, after the Exchange halted trading in Lum's shares, Lum's publicly announced the reduced earnings forecast. Trading did not resume until the following Monday, when the closing price fell to $14.00 per share.

It is important to note at the outset that the plaintiffs in these actions, shareholders of Lum's, do not claim to have suffered any damages themselves. Rather, these derivative suits are brought "on behalf of and for the benefit of Lum's." They seek to recover for Lum's treasury the windfall profit garnered by the IDS mutual funds, and assert that all defendants are jointly and severally liable for this amount. Thus, the proper method of analysis is not to focus on the unfairness of the mutual funds' profit at the expense of their purchasers—who have their own recourse for any wrongdoing—but on the strands of duty running to the corporation from the various individuals involved. The crux of the majority's holding is that the institutional defendants—Lehman Brothers, IDS, and the two mutual funds—and their employees—Simon, Sit, and Jundt—are within the sweep of fiduciary principles announced in *Diamond* v. *Oreamuno,* 24 N.Y.2d 494, 301 N.Y.S. 2d 78 (1969). But a careful examination of that case and the principles underlying it demonstrate that *Diamond* is wholly inapposite to this case.

In *Diamond,* the New York Court of Appeals dealt with a derivative action brought by a shareholder of Management Assistance, Inc. (MAI) against Oreamuno, chairman of the board of directors of the corporation, and Gonzalez, its president. The complaint charged that by virtue of

their corporate positions, these officers knew that a supplier's price increase had caused MAI's earnings to decrease by more than 75% during a one month period. According to the allegations, the two officers sold over 50,000 MAI shares at a price of $28 per share prior to public disclosure of the adverse earnings figures, after which the price per share plummetted to $11. In reviewing the Appellate Division's refusal to order dismissal of the complaint against Oreamuno and Gonzalez, Chief Judge Fuld stated at the outset that "the question presented—one of first impression in this court—is whether *officers and directors* may be held accountable to their corporation for gains realized by them from transactions in the company's stock as a result of their use of material inside information." 24 N.Y.2d at 496, 301 N.Y.S.2d at 79 (emphasis added). A careful reading of the *Diamond* opinion reveals that Oreamuno's and Gonzalez's liability in a stockholders' derivative action was grounded solely in their having breached a fiduciary duty owed by them to MAI as corporate officials.

The inapplicability of these principles to any of the appellees[2] is readily apparent. The complaints here are barren of any allegation that the appellees—or Sit or Jundt—occupied any position, such as officer, director, employee, or agent, which would create fiduciary obligations to Lum's. *Compare* Brophy v. Cities Service Co., 31 Del.

2. As noted in the majority opinion, the only defendants remaining on appeal are Lehman Brothers, IDS, the two mutual funds, and Simon. The district court dismissed the actions against Chasen for lack of personal jurisdiction, a holding not challenged on appeal. Accordingly, this court need not comment on the nature and extent of Chasen's liability to Lum's because of his conduct.

Ch. 241, 70 A.2d 5 (1949); Quinn v. Phipps, 93 Fla. 805, 113 So. 419 (1927). Liability in *Diamond* was predicated entirely on such a relationship, and in its absence, the *Diamond* rationale for liability ceases to exist.

In an effort to bridge this fatal gap, the majority, without any basis in law or fact, reasons that the appellees were involved in a "joint" or "common enterprise" with Chasen, president of Lum's, "to misuse confidential corporate information for their own enrichment." By use of this interesting, but nevertheless fictional, theory, they seek to foist upon the appellees liability to Lum's for Chasen's improper behavior. But the facts alleged in the complaints are a far cry from the "conscious parallelism" cases, drawn from the antitrust field, cited as authority in the majority opinion; the facts simply do not comport with the concept of a joint enterprise, a term which implies the existence of a prior plan to carry out a mutually beneficial project. The complaints, read in the most favorable light to the plaintiffs, disclose nothing more than a seemingly unsolicited and haphazard revelation of certain information which was useful in making investment decisions. There are ample remedies under the federal securities laws to punish this conduct. But, I am unable to understand on what basis the majority transforms the 'appellees' spontaneous conduct into a nefarious, prearranged, and ongoing scheme so that "joint" or "common enterprise" priciples can make them liable as fiduciaries of a corporation with which they have no relationship.

A primary authority upon which the majority relies, §312 of the American Law Institute's Restatement of Agency 2d, exposes the inappropriateness of holding the

appellees liable to Lum's for their conduct. Section 312 provides that "A person who, without being privileged to do so, intentionally causes or assists an agent to violate a duty to his principal is subject to liability to the principal." Although Comment *c* to this section speaks generally of receipt of confidential information by a third person from a principal's agent, the central element of liability is the third party's active and intentional aiding in the agent's violation of a duty owed to his principal. In this case, Chasen's duty to Lum's was to not disclose confidential corporate information. Yet there is not a word in the complaint charging that the appellees actively solicited the disclosure or that they had concocted a prearranged scheme with Chasen.[3] We are dealing here with an isolated transaction.

In the absence of any coherent legal theory, I cannot join my brothers in approving the use of the shareholders' derivative action device merely because, as my brothers candidly admit, to do so possibly may have a deterrent effect on "insider trading." Although developments in federal securities law indicate an expanding scope of liability for tippee traders, *see In re* Investors Management Co.,

3. It is of no small significance that in the *Diamond* litigation, the Appellate Division affirmed dismissal of the complaint against other MAI directors—fiduciaries to the corporation—who allegedly "approved, acquiesced in or ratified" Oreamuno's and Gonzalez's transactions. 29 A.D.2d 285, 287 N.Y.S.2d 300 (1968). Despite the majority's effort in a footnote to "distinguish" this disposition, I believe the Appellate Division's action is clearly dispositive of the point before us. If the New York courts would not impose liability upon a director—a fiduciary of the corporation—who took no affirmative steps to cause or assist in a breach of a fiduciary duty by the corporation's president, I fail to see by what logic it can be urged that New York courts would hold liable a non-fiduciary who did not cause or assist in the breach.

Securities and Exchange Commission Release No. 34-9267 (Jul. 29, 1971) (SEC sanctioning of institutional investors who sold a corporation's shares after the corporation's underwriter revealed adverse earnings results to them); *cf.* SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1308 (2d Cir. 1971), *cert. denied,* 404 U.S. 1005 (1972) (affirming district court order, in SEC injunctive suit, requiring a "tippor" to divest an amount equal to his tippees' profits), the impetus for developing this expanded federal law liability—whose exact nature and scope remain in a formative stage—is the need to maintain free and honest securities markets. This need appropriately is given great weight when we consider claims under the federal securities law. But it is inapposite in determining whether, *under state common law,* tippee trading is a breach of a fiduciary duty owed to the corporation whose shares are traded, and if so, whether such a breach is remediable through use of a shareholders' derivative action.

In these actions, where jurisdiction is grounded solely in diversity of citizenship, the parties and the majority agree that our duty is to apply the law of Florida. Yet because there are no pertinent Florida decisions, the majority focuses on a New York decision, Diamond v. Oreamuno, *supra.* Thus, liability is founded on the conclusion of two federal judges that the Florida Supreme Court, if the instant case was before it, would look to a New York decision and, in addition, would give an unprecedented expansive reading to that case.

Despite the manner in which the majority opinion convolutes the law and the facts in this case, a view that a

tippee is cloaked with state law fiduciary obligations to the corporation whose shares he trades is an unknown and untenable legal concept. Neither *Diamond*—itself a significant alteration of the common law principles applicable to an officer's or director's trading in his corporation shares[4]—nor the law of agency support such a holding. Nothing in the majority opinion tells us why or on what grounds a New York court would hold a tippee trader liable to the corporation for his profits under common law fiduciary principles, and the court exceeds its authority by substituting its own view of what state law ought to be, for what the state law actually is.

Moreover, since the outcome of this case turns, ultimately, upon Florida law, I fail to comprehend why my brothers refuse to utilize Florida's certified question statute, Fla. Stat. Ann. §25.031.[5] This enlightened law provides for certification to the Florida Supreme Court by a federal appellate court of an unresolved question of Florida law

4. *See* Note, 1970 Wis. L. Rev. 576, 577. Although not dispositive, this fact augurs against assuming the state courts could make the broad holding so readily attributed to them by the majority.

5. The supreme court of this state may, by rule of court, provide that, when it shall appear to the supreme court of the United States, to any circuit court of appeals of the United States, or to the court of appeals of the District of Columbia, that there are involved in any proceeding before it questions or propositions of the laws of this state, which are determinative of the said cause, and there are no clear controlling precedents in the decisions of the supreme court of this state, such federal appellate court may certify such questions or propositions of the laws of this state to the supreme court of this state for instructions concerning such questions or proposition of state law, which certificate the supreme court of this state, by written opinion, may answer.

This statutory authority has been implemented by Appellate Rule 4.61.

which is determinative of a case before it and on which there are no clear, controlling Florida Supreme Court precedents. The statute states that the court, by written opinion, then may answer the certified question. *See* Aldrich v. Aldrich, 375 U.S. 249 (1963); Green v. American Tobacco Co., 304 F. 2d 170 (5th Cir. 1962). The uncertainty inherent in the majority's speculation over what the Florida courts would decide if faced with this novel question of tippee liability under state common law fiduciary principles in a stockholders' derivative action would be dispelled authoritatively and finally.

Accordingly, I respectfully dissent.

Appendix B

Opinion of the District Court for the Southern District of New York, December 16, 1971 reported *sub nom.*, *Gildenhorn* v. *Lum's Inc.*, 355 F. Supp. 329 (S.D.N.Y. 1971)

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

70 Civ. 5733 HRT

JOSEPH GILDENHORN, as Guardian for CAROL ANN GILDENHORN,

Plaintiff,

against

LUM'S INC., MELVIN CHASEN, LEHMAN BROTHERS, INVESTORS DIVERSIFIED SERVICES, INC., INVESTORS VARIABLE FUND, INC., and IDS NEW DIMENSIONS FUND, INC.,

Defendants.

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71 Civ. 1925 HRT

ANTONE F. GREGORIO,

Plaintiff,

against

LUM'S INC., MELVIN CHASEN, LEHMAN BROTHERS, INVESTORS DIVERSIFIED SERVICES, INC., EUGENE C. SIT, and JAMES R. JUNDT,

Defendants.

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71 Civ. 4218 HRT

JACOB SCHEIN and MARVIN H. SCHEIN,

Plaintiffs,

against

MELVIN CHASEN, INVESTORS DIVERSIFIED SERVICES, INC., LEHMAN BROTHERS, BENJAMIN SIMON, INVESTORS VARIABLE PAYMENT FUND, INC., IDS NEW DIMENSIONS FUND, INC., EUGENE C. SIT, JAMES R. JUNDT, and LUM'S INC.,

Defendants.

Appendix B—Opinion of the District Court

TYLER, D.J.

Defendants in these consolidated actions have moved to dismiss plaintiffs' complaints upon the ground that they fail to state a claim upon which relief can be granted. Rule 12(b)(6) F.R. Civ. P. Alternatively, all defendants move this court to stay these actions pending a final determination in *Sanders* v. *Lum's, Inc. et al.,* 70 Civ. 5331, a related action pending before this court. Additionally, the individual defendants move that the complaints be dismissed as against them upon the ground that jurisdiction over their persons has not been obtained. Rules 4(e) and 12(b)(2), F.R. Civ. P.[1]

All three of these suits are derivative actions brought on behalf of Lum's Inc. ("Lum's"), a Florida corporation. Jurisdiction is claimed by virtue of diversity of citizenship. The plaintiffs' complaints are predicated on the same facts as *S.E.C.* v. *Lum's et al.,* 70 Civ. 5280, which is also pending before this court. Briefly stated, plaintiffs' claims are based on defendants' alleged misuse of confidential corporate information. The complaints charge that defendant Melvin E. Chasen, aware as president of Lum's that the firm's 1969 earnings would be lower than had been projected, telephoned from his Florida office to defendant Simon, who is employed in the Chicago, Illinois office of defendant Lehman Brothers, Inc., and told him of the earnings' decline. Simon then transmitted the information to

1. Defendants Sit and Jundt, apparently unaware that I have already granted their prior motions to dismiss by order dated October 25 of this year, once again seek the same relief. As they are no longer defendants in any of these actions, their applications will not be considered.

Sit, the portfolio manager at defendant IDS New Dimensions Fund ("Dimensions"), whose offices are in Minneapolis, Minnesota. Sit then conveyed the information to defendant Jundt, a manager and analyst for IDS Variable Payment Fund ("Variable"). It is further alleged that Sit and Jundt then caused Variable and Dimensions to sell their entire holdings in Lum's just before the public announcement of the decline in the 1969 earnings caused the stock to drop several points in trading on the New York Stock Exchange.

Plaintiffs make no argument that any of the federal securities acts would support a claim under the facts of this case. They do argue, however, that a claim for which relief can be granted can be made out under the recent decision of the New York Court of Appeals in *Diamond* v. *Oreamuno,* 24 N.Y. 2d 494, 301 N.Y.S. 2d 78 (1969). Briefly stated, that case held that corporate officers who learn of a drop in corporate earnings by virtue of their fiduciary positions and sell their shares of corporate stock before publishing information as to the loss will be liable to the corporation for any profits made thereby. Plaintiffs urge that Chasen be found liable under *Diamond* even though it is not alleged that he sold any Lum's stock belonging to him and that the remaining defendants be so held under either a "tippee" or general conspiracy theory.

Three issues, thus, are presented to this court by these motions, the first being a choice of law problem. The defendants argue that under the applicable choice of law provisions, these cases should be decided by Florida law. Plaintiffs oppose and urge that their complaints be tested

by New York law in general and by *Diamond* v. *Oreamuno, supra,* in particular. Assuming that *Diamond would apply,* this court would then have to determine whether the complaints herein can state a claim under the holding of that case. Finally, it must be decided whether the activities of the individual defendants fall within any of the provisions of the New York long-arm statute, CPLR §302(a), so as to allow out of state service to be effected upon them pursuant to CPLR §313.

In actions where jurisdiction is predicated on diversity of citizenship, this court must apply the choice of law rules of the State of New York. *Klaxon Co.* v. *Stentor Electric Mfg. Co.,* 313 U.S. 487 (1941). New York follows the general choice of law principle that the law of the state of incorporation governs the existence and extent of corporate fiduciary obligations as well as the liability for violations of such obligations. *Hausman* v. *Buckley,* 299 F.2d 696, 703 (2d Cir., 1962) and cases cited therein; *Norte & Co.* v. *Huffines,* 304 F. Supp. 1096, 1110 n.6 (S.D.N.Y., 1968). This rule was expressed in *Diamond* itself when the court stated that as regards the "* * * duties and obligations of directors and officers and their relation to the corporation and its shareholders * * * [t]he primary source of law in this area ever remains that of the state which created the corporation." *Diamond* v. *Oreamuno, supra,* at 503, 504, 301 N.Y.S. 2d at 35.

The same result would be reached by the "grouping of contacts" approach to choice of law in tort actions as enunciated in *Babcock* v. *Jackson,* 12 N.Y. 2d 473, 240 N.Y.S. 2d 743 (1963). Under this approach, a New York court will

apply the law of the state of the "strongest contacts with the cause of action." *Stockwell* v. *Reynolds & Co.*, 252 F. Supp. 215, 220 n.3 (S.D.N.Y., 1965). It appears from the pleadings that this case centers in Florida rather than in New York. Chasen, a Florida citizen, allegedly received and communicated the information from Florida. Lum's was incorporated, headquartered, and, at least theoretically, damaged in Florida. Most of the other contacts appear to be scattered about the midwest, the only contact with New York being several transactions over the New York Stock Exchange. Additionally, a New York court would give more weight to the Florida contacts under the "governmental interest" theory of choice of law enunciated in *Tooker* v. *Lopez*, 24 N.Y. 2d 569, 301 N.Y.S. 2d 519 (1969), because Florida has the paramount interest in defining and enforcing fiduciary obligations owing to corporations incorporated and doing business within its borders. Accordingly, I find that under any conceivable test, a New York court would apply Florida law to this case.

Under present Florida case law, a plaintiff in a derivative action must prove that the corporation has been damaged by the alleged breach of fiduciary trust. Although the highest court in that state has apparently not considered the matter, several District Courts of Appeal have held on various occasions that a complaint which fails "* * * to indicate both wrongful acts and damage to the corporation" must be dismissed. *Palma* v. *Zerby*, 189 So.2d 510, 511 (Fla. D.C. App., 1966), *cert. denied* 200 So.2d 814 (and cases cited therein).

While it is apparently required that the damage to a corporation be alleged, the Florida cases shed no light on

the specificity required for pleading corporate damage. Thus, though the Gildenhorn and Gregorio complaints might be insufficient under Florida law for failing to allege any damage to the corporation at all, the Schein complaint, which contains only a bare allegation that Lum's was damaged, might conceivably be held to he sufficient by a Florida court. Furthermore, I am not unmindful of the possibility that, were a Florida court to hear this case, *Diamond* v. *Oreamuno, supra,* would be argued to it. Because of the possibility that the *Diamond* rationale might be followed in Florida, it is desirable that this court determine whether these complaints state a claim under *Diamond* for which relief can be granted.

It is clear that the complaints in these actions go far beyond the narrow holding of *Diamond.* In that case, the New York Court of Appeals held that a corporate fiduciary is liable for profits which he realizes from a sale of stock motivated by inside information received by him in his corporate position. None of the defendants in these actions fit into this mold. Chasen, as president and chief operating officer of Lum's, was certainly a fiduciary of that corporation. None of the complaints, however, allege that he did anything more than pass the inside information to defendant Simon, and there are no allegations that Chasen sold any of his Lum's stock or derived any gain, monetary or otherwise, from the sales that ultimately occurred. On the other hand, the mutual fund defendants would have profited if, as alleged, they sold their 83,000 shares of Lum's stock on the basis of Chasen's inside information. It can scarcely be maintained, however, that the mutual fund defendants were officers or directors of Lum's or

owed any fiduciary duties whatsoever to that corporation. The broker-dealer defendants fail to come within either of the *Diamond* perameters as they were not fiduciaries of the corporation and did not profit by virtue of the sales.

Plaintiffs, of course, urge a more expansive view of *Diamond*. They point to portions of the opinion indicating that the purpose of the holding was to protect the corporation's interest in "* * * maintaining a reputation of integrity, an image of probity for its management and in insuring the continued public acceptance and marketability of its stock." *Diamond* v. *Oreamuno, supra,* at 499, 301 N.Y.S. 2d at 82. Thus, say plaintiffs, if the purpose of *Diamond* is to maintain a corporation's integrity on the securities exchanges, it should make no difference whether an officer or director sells his own stock or passes the inside information to others who in turn sell their stock and profit thereby. While the harm done to the corporation might be equal in either instance, there is evidence that *Diamond* was not intended to cover the latter situation. As Chief Judge Fuld explained, the purpose of that derivative action was to allow individual shareholders to be "* * * 'private attorney generals' to * * * enforce proper behavior of corporate officers." *Diamond* v. *Oreamuno, supra,* at 503, 301 N.Y.S. 2d at 85. It is implicit that the jurisdiction of these "private attorney generals" would be limited to the corporation in which they are shareholders. It could not, with any logic, be extended in a derivative action to cover outside individuals, corporations, or institutions who are subject ot other private and governmental restraints on their behavior. Furthermore, in affirming the dismissal of the

Diamond complaint against other board members who were alleged to have aided the defendants in concealing their activities, the New York Court of Appeals made it quite clear that *Diamond* extends only to corporate fiduciaries who actually profit by inside information and does not cover aiders and abettors and/or conspirators. In view of the fact that the New York Court of Appeals could not bring itself to find liability for inter-corporate conspirators, I fail to perceive how this court could extend *Diamond* to cover extra-corporate conspirators and tippees. Accordingly, I conclude that with regard to all defendants save Chasen, the complaints herein fail to state a claim for which relief can be granted.

On the other had, Chasen, as a corporate officer, might well come within the *Diamond* holding. Although it could be plausibly argued that *Diamond* would not apply to Chasen because of the failure to allege that he sold any stock and profited thereby, it might also be maintained that a New York court could find liability in light of the numerous statements in *Diamond* to the effect that the purpose of the holding is to prevent corporate misfeasance. This question, however, need not be reached because service of process upon Chasen was improper.

In diversity actions, this court's jurisdiction is determined by the law of the State of New York. Rule 4(d)(7), F.R. Civ. P. Because Chasen is not a New York resident and was not served in New York, jurisdiction of his person depends on the New York long-arm statute, CPLR §302(a). It is plaintiffs' assertion that jurisdiction was obtained over Chasen because he set in motion events which cul-

minated with the alleged sale of 83,000 shares of Lum's stock over an exchange located in New York. While I am aware that the scope of CPLR §302(a) has been broadly construed, I fail to see how it can be read to cover the facts in this case.

While it is settled that one can "transact business" within the meaning of CPLR §302(a)(1) through an agent, *Parke-Bernet Galleries, Inc.* v. *Franklyn,* 26 N.Y.2d 13, 308 N.Y.S. 2d 337 (1970), a New York Court would decline jurisdiction of a defendant who merely telephones a single order from outside the state. *Katz & Son Billiard Prods.* v. *Correale & Sons,* 20 N.Y. 2d 903, 285 N.Y.S. 2d 871 (1967). It seems obvious that Chasen, who did not place the order to sell the Lum's stock in question, did not "purposefully" avail himself "of the privilege of conducting activities" within New York, thereby "invoking the benefits and protections of its laws." *Hanson* v. *Denckla,* 357 U.S. 235, 253 (1958).

Plaintiffs next argue that the sale of stock over a national exchange in New York was a "tortious act within the state" and that jurisdiction could be found under CPLR §302(a)(2). While such a sale will confer jurisdiction in some cases, *Cooper* v. *North Jersey Trust Co. of Ridgewood, New Jersey,* 250 F. Supp. 237 (S.D.N.Y., 1965), CPLR §302(a)(2) can apply only where the non-resident defendant committed the tort in New York. That the alleged tort here may have been completed or "came to rest" in New York will not confer jurisdiction unless the acts or omissions complained of also occurred in New York. *Feathers* v. *McLucas,* 15 N.Y. 2d 426, 261 N.Y.S. 2d 8

(1965). *Cooper* v. *North Jersey Trust Co. etc., supra,* is not inconsistent as the defendants in that case were physically in New York when they allegedly committed the tort there in issue. As it is nowhere alleged that Chasen committed a tortious act in New York, no jurisdiction of his person can be claimed under CPLR §302(a)(2).

Finally, there can be no jurisdiction under CPLR §302 (a)(3). As the statute clearly states, the tortious act must cause injury to persons or property in New York. Insofar as none of the non-resident plaintiffs in these cases have alleged that any injury occurred in New York, their invocation of this provision is futile.

Defendant Chasen's motion to dismiss is granted on the ground that no jurisdiction was ever obtained of his person. Rule 12(b)(2) F.R. Civ. P. The motions of the remaining defendants to dismiss under Rule 12(b)(6) F.R. Civ. P. are hereby granted. In view of these rulings, defendants' alternative motion for a stay of these actions need not be reached.

Settle orders accordingly.

Dated: December 15, 1971

H. R. Tyler, Jr.
U.S.D.J.